No. 06-1413

Title:	MeadWestvaco Corporation, Successor in Interest to The Mead Corporation, Petitioner v. Illinois Department of Revenue, et al.
Docketed:	April 25, 2007
Lower Ct:	Appellate Court of Illinois, First District
Case Nos.:	(1-03-1160)
Decision Date:	January 12, 2007
Discretionary Court Decision Date:	January 24, 2007

Questions Presented

~~Date~~~	~~~~~~~Proceedings and Orders~~~~~~~~~~~~~~~~~~~~~~
Apr 20 2007	Petition for a writ of certiorari filed. (Response due May 25, 2007)
May 2 2007	Waiver of right of respondents Illinois Department of Revenue, et al. to respond filed.
May 11 2007	Brief amicus curiae of Gannett Co., Inc. filed. (Distributed)
May 14 2007	Brief amicus curiae of Council On State Taxation filed.
May 15 2007	DISTRIBUTED for Conference of May 31, 2007.
May 17 2007	Response Requested . (Due June 18, 2007)
Jun 7 2007	Order extending time to file response to petition to and including July 18, 2007.
Jul 18 2007	Brief of respondents Illinois Department of Revenue, et al. in opposition filed.
Jul 18 2007	Brief amicus curiae of Tax Executives Institute, Inc. filed.
Jul 27 2007	Reply of petitioner MeadWestvaco Corporation filed.
Aug 1 2007	DISTRIBUTED for Conference of September 24, 2007.
Aug 16 2007	Letter and attachment received from counsel for the respondent.
Sep 25 2007	Petition GRANTED. The brief of petitioner is to be filed with the Clerk and served upon opposing counsel on or before 2 p.m., Monday, November 5, 2007. The brief of respondents is to be filed with the Clerk and served upon opposing counsel on or before 2 p.m., Monday, December 3, 2007. A reply brief, if any, is to be filed with the Clerk and served upon opposing counsel on or before 2 p.m., Friday, December 28, 2007. Briefs of amici curiae are to be filed with the Clerk and served upon counsel for the parties on or before 2 p.m., 7 days after the brief for the party supported is filed, or if in support of neither party, within 7 days after the petitioner's brief is filed.
Nov 5 2007	Joint appendix filed. (Statement of costs filed)
Nov 5 2007	Brief of petitioner MeadWestvaco Corporation filed.
Nov 9 2007	Brief amicus curiae of Gannett Co., Inc. filed.
Nov 13 2007	Brief amicus curiae of Tax Executives Institute, Inc. filed.
Nov 13 2007	Brief amicus curiae of Walt Disney Company filed.
Nov 13 2007	Brief amici curiae of Council on State Taxation and National Association of Manufacturers filed.
Nov 16 2007	SET FOR ARGUMENT ON Wednesday, January 16, 2008.
Dec 3 2007	Brief of respondents Illinois Department of Revenue, et al. filed.
Dec 10 2007	Brief amici curiae of California, et al. filed.
Dec 10 2007	Brief amicus curiae of Multistate Tax Commission filed.

Dec 12 2007	CIRCULATED.
Dec 19 2007	Record received from the Appellate Court First District of Illinois. (1 envelope)
Dec 27 2007	Reply of petitioner MeadWestvaco Corporation filed. (Distributed)
Jan 15 2008	Trial court record received from the Law Offices of Morrison Forester LLP. (2 boxes)
Jan 16 2008	Argued. For petitioner: Beth S. Brinkmann, Washington, D.C. For respondents: Brian F. Barov, Assistant Attorney General, Chicago, Ill.

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No. 061413 APR 20 2007

OFFICE OF THE CLERK

In The

Supreme Court of the United States

MEADWESTVACO CORPORATION,
successor in interest to THE MEAD CORPORATION,

Petitioner,

v.

ILLINOIS DEPARTMENT OF REVENUE, DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE, AND TREASURER OF THE STATE OF ILLINOIS,

Respondents.

On Petition For A Writ Of Certiorari To The Appellate Court Of Illinois

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Is the attempt by Illinois to tax the approximately $1 billion gain realized by Petitioner when it sold its investment in Lexis/Nexis in 1994 (which it acquired in 1968 for $6 million and which functioned for 26 years as an independent, nonunitary business) in direct conflict with the decisions of the Court in *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), *F.W. Woolworth Co. v. Taxation & Revenue Department of New Mexico*, 458 U.S. 354 (1982) and *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982) and the Due Process and Commerce Clauses of the United States Constitution?

RULE 29.6 STATEMENT

Petitioner, The Mead Corporation, was a publicly held company with no parent company or publicly held company owning more than 10% of the Company's stock during the year ended December 31, 1994, the tax period involved in the dispute. As of January 29, 2002, MeadWestvaco Corporation was formed. From January 29, 2002 through December 31, 2002, MeadWestvaco Corporation functioned as a holding company with two assets – all of the stock of The Mead Corporation and all of the stock of Westvaco Corporation. On December 19, 2002, MW Custom Papers, Inc. was incorporated. On December 31, 2002, The Mead Corporation was merged into MW Custom Papers, Inc. Later on December 31, 2002 MW Custom Papers, Inc. was converted into MW Custom Papers, LLC. After this conversion, the majority of the operations and assets previously owned by The Mead Corporation and then contained within MW Custom Papers, LLC were transferred to MeadWestvaco Corporation. MeadWestvaco Corporation is the successor in interest to The Mead Corporation. MeadWestvaco Corporation is a publicly held company with no parent company or publicly held company owning more than 10% of MeadWestvaco Corporation's stock.

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PETITION FOR A WRIT OF CERTIORARI

Petitioner respectfully seeks this Court's review of the January 12, 2007 opinion of the Appellate Court of Illinois, First Judicial District, Sixth Division and the January 24, 2007 Denial of the Supreme Court of Illinois of the Petition for Leave to Appeal.

OPINIONS BELOW

The Denial of the Supreme Court of Illinois of the Petition for Leave to Appeal (Petition Appendix ("App.") 41a), dated January 24, 2007, is reported at 862 N.E.2d 235. The opinion of the Appellate Court of Illinois, First Judicial District, Sixth Division (App. 1a-22a), dated January 12, 2007, is reported at 861 N.E.2d 1131. The order of the Appellate Court of Illinois, First Judicial District, granting the Respondents' motion to publish a Rule 23 order as a precedential decision and withdrawing the Rule 23 order issued on November 3, 2006 (App. 23a-24a), dated January 3, 2007, is not reported. The Memorandum Decision, Judgment and Order of the Circuit Court of Cook County, Illinois (App. 28a-40a) filed on March 18, 2003, is not reported. The Final Judgment Order of the Circuit Court of Cook County, Illinois (App. 25a-27a) entered on March 25, 2003, was not reported.

JURISDICTION

The opinion of the Appellate Court of Illinois, First Judicial District, Sixth Division (App. 1a-22a), was rendered on January 12, 2007. The Denial of the Supreme Court of Illinois of the Petition for Leave to Appeal (App.

41a), was issued on January 24, 2007. The jurisdiction of this Court rests upon 28 U.S.C. § 1257(a).

CONSTITUTIONAL PROVISIONS INVOLVED

The United States Constitution provides: "The Congress shall have the Power . . . [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." U.S. Const. art. I, § 8, cl. 3 (the Commerce Clause).

The Fourteenth Amendment to the United States Constitution provides: "No State shall . . . deprive any person of life, liberty, or property, without due process of law." U.S. Const. amend. XIV, § 1 (the Due Process Clause).

INTRODUCTION

This Petition presents the question whether Illinois can violate the principles set forth in *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), *F.W. Woolworth Co. v. Taxation & Revenue Department of New Mexico*, 458 U.S. 354 (1982) and *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982) and the Due Process and Commerce Clauses of the United States Constitution, by ignoring the factors articulated by this Court in determining whether an asset serves an operational function such that income from the sale of that asset can be subjected to tax by a non-domiciliary state. Furthermore, and again in direct contravention of the principles articulated by this Court, the factors relied upon

by Illinois in reaching its determination would almost always in today's business world lead to a conclusion that an operational relationship exists where one business owns another. Consequently, if the Illinois decision is allowed to stand it will eviscerate the operational test articulated by this Court and result in virtually all income being subject to apportionment.

Petitioner acquired Data Corporation, which became Mead Data Central, in 1968 for $6 million. One of the technologies included in this acquisition was an experimental full-text information retrieval technology which, for the first time, applied computers to legal research and eventually became the Lexis/Nexis information service (this business will be referred to as "Lexis/Nexis").

Petitioner was, and is, in the business of producing and selling forest products, including paper and school supplies. Lexis/Nexis was in the electronic publishing business.

Lexis/Nexis did not receive its big break until the 1970s when this Court became a customer, leading to courts at every level becoming customers, which inevitably led to law firms, law schools and the entire legal profession becoming customers. Lexis/Nexis grew from a small legal database into the world's premier provider of online legal information.

The controversy in this matter stems from Petitioner's gain from the liquidation of its investment in this completely separate business, Lexis/Nexis, in 1994 (the "gain") and Respondents' taxation of the gain. It is Petitioner's position that, as a non-domiciliary of Illinois, Illinois cannot tax the gain because Petitioner's

investment in Lexis/Nexis served an investment as opposed to an operational function in accordance with this Court's decisions in *Allied-Signal*, *Woolworth* and *ASARCO*.

As concluded by the trial court, Lexis/Nexis did not engage in a unitary business with Petitioner. Specifically, the trial court found that Petitioner and Lexis/Nexis "were not functionally integrated, there was no centralization of management and no significant economies of scale between the two businesses." App. 39a. Despite the fact that Petitioner and Lexis/Nexis were in two distinct businesses, the trial court went on to find, and the appellate court concurred, without foundation, that Petitioner's investment in Lexis/Nexis served an operational rather than investment function.

The factors relied upon by the appellate court as indicative of Lexis/Nexis serving Petitioner in an operational rather than investment function start with the fact that Petitioner owned 100% of Lexis/Nexis. However, this Court has held that income received by a non-domiciliary corporation from wholly owned subsidiaries was not apportionable to New Mexico where there did not exist a unitary relationship between the parent and the subsidiaries. *F.W. Woolworth Co. v. Taxation & Revenue Dep't of N.M.*, 458 U.S. 354, 370 (1982).

The remainder of the factors relied upon by the appellate court all stem from this first factor, *i.e.*, the remaining factors all reflect an ordinary relationship between a company and a 100% owned business. Such factors were: (1) Petitioner's capital investment in the early years of Lexis/Nexis; (2) Petitioner's receipt of the

benefit of certain tax advantages; (3) Petitioner's investment of Lexis/Nexis' excess cash (for the benefit of Lexis/Nexis); (4) Petitioner's approval of major debt and major capital expenditures; (5) Petitioner's ability to change Lexis/Nexis from a division to a subsidiary; and (6) Petitioner's inclusion of Lexis/Nexis in describing the company's business in its annual reports and Forms 10-K.

These factors, however, exist in virtually every situation where one business owns another. If allowed to stand, reliance by Illinois on these factors would render this Court's holding setting forth the operational requirement in *Allied-Signal* meaningless. It would mean that all income received by non-domiciliary corporations from subsidiaries or divisions would be subject to apportionment. This is precisely what New Jersey argued for in *Allied-Signal*. This Court responded that the unitary business principle has existed since the beginning of the twentieth century, that it is workable in practice, and that to overrule it at this late date would make it unworkable in practice. Illinois cannot be allowed to circumvent this Court's holding in *Allied-Signal*.

STATEMENT OF THE CASE

As the appellate court recognized, the facts in this matter are "essentially undisputed." App. 2a.

A. Petitioner's Business

At all times relevant hereto, Petitioner was a corporation incorporated under the laws of Ohio that maintained its commercial domicile in Dayton, Ohio.

Petitioner was, and is, in the business of producing and selling forest products, including paper, packaging and school and office supplies.

In 1968, Petitioner acquired Data Corporation because it was interested in its ink jet printing technology. Data Corporation also had two other technologies, one of which was a full-text experimental information retrieval technology which was the predecessor of Lexis/Nexis. Lexis/Nexis developed the information retrieval technology, in a project with the Ohio and Missouri Bar Associations, into a service that would assist in researching law. This project lasted until 1972, when it was decided to develop this service on a national basis. Lexis was launched in 1973.

Lexis/Nexis received a big break in the 1970s when this Court became a customer. Courts at every level soon became customers, which inevitably led to law firms, law schools and the rest of the profession becoming customers. Nexis, a news and information service aimed at the financial market, was launched in approximately 1980.

Lexis/Nexis had its own building in Miamisburg, Ohio. Petitioner was located at its corporate headquarters in downtown Dayton, Ohio. Lexis/Nexis maintained its own facilities that were separate from the facilities maintained by Petitioner. There were no shared facilities between Petitioner and Lexis/Nexis.

Lexis/Nexis was responsible for all of its own personnel matters. Bonuses for Lexis/Nexis personnel were based upon the performance of Lexis/Nexis measured against its business plan. There were many years when Lexis/Nexis employees received bonuses while Petitioner's employees did not.

There were no shared departments between Petitioner and Lexis/Nexis. For example, Lexis/Nexis maintained the following departments, all of which were separate from Petitioner: accounting; internal audit; internal legal; credit and collection; human resources; real estate; purchasing; and marketing.

While Lexis/Nexis could have invested its own excess funds, Petitioner invested cash for Lexis/Nexis. However, the funds and the investment returned on those funds accrued specifically to Lexis/Nexis.

Petitioner exercised very little control over the capital acquisitions of Lexis/Nexis. Lexis/Nexis made its own purchases based upon its business plan. As would any investor in a company, Petitioner's board of directors reviewed and approved major capital expenditures by Lexis/Nexis, changes to Lexis/Nexis' legal structure and other large, nonrecurring transactions. Petitioner also made some capital contributions to Lexis/Nexis.

While the legal relationship between Petitioner and Lexis/Nexis changed several times between a division and a subsidiary, this did not affect the operations of Lexis/Nexis. Indeed, most people at Lexis/Nexis were not even aware of any changes.

To Petitioner, Lexis/Nexis was simply an investment. Petitioner therefore let the company run itself. Once a year, Lexis/Nexis management would present a business plan to Petitioner and that was the extent of Petitioner's involvement in the operations of Lexis/Nexis.

The Illinois Department of Revenue's auditor conceded that Petitioner and Lexis/Nexis were not in the same line of business or vertically integrated. Furthermore, he conceded

that there was no functional integration between Petitioner and Lexis/Nexis, *nor was there any operational relationship between the businesses.* Simply stated, Illinois' own auditor acknowledged that Petitioner was a passive investor in Lexis/Nexis.

On December 2, 1994, Petitioner announced the completion of the sale of Lexis/Nexis for approximately $1.5 billion. Petitioner is contesting the actions of Illinois in seeking to tax the $1,056,001,948.00 gain from that sale reported by Petitioner as nonapportionable income on its Illinois return for the tax year 1994.

B. Proceedings Below

The Illinois Department of Revenue issued two notices of deficiency to Petitioner asserting that, among other issues that are not the subject of this Petition, Petitioner was to apportion the gain from the sale of Lexis/Nexis to Illinois. Petitioner filed this action in the Circuit Court of Cook County Illinois asserting, as relevant to this Petition, that Petitioner did not have a unitary relationship with Lexis/Nexis, nor did Petitioner's investment in and disposition of Lexis/Nexis serve an operational, as opposed to an investment, function.

During the trial before the Circuit Court of Cook County, several expert witnesses in tax policy and one expert witness in economics testified and submitted their reports detailing their findings. Professor Walter Hellerstein, renowned in the state and local tax community, testified and provided a report as an expert witness in state tax policy. App. 48a-58a. With regard to any operational relationship that might have existed

between Petitioner and Lexis/Nexis, Professor Hellerstein opined in his report:

> In summary, because the relationship between Mead and MDC involved no meaningful functional integration, centralized management, or economies of scale; because there was no significant flow of value between Mead and MDC; and because neither Mead nor MDC served an operational function in each other's business, Illinois lacks the power to include the gain that Mead (a nondomiciliary corporation) earned from its disposition of MDC.

App. 57a. (Mead being Petitioner and MDC being Lexis/Nexis.)

Professor Richard D. Pomp, also renowned in the state and local tax community, testified and provided a report as an expert witness in state tax policy. App. 59a-77a. With regard to any operational relationship that might have existed between Petitioner and Lexis/Nexis, Professor Pomp opined in his report:

> Based upon the above facts and applying the governing principles of state tax policy, my opinion is that Mead and Lexis/Nexis were separate businesses. Lexis/Nexis did not contribute to Mead's unitary paper business, nor was Mead's unitary paper business dependent upon Lexis/Nexis. Accordingly, I conclude that from a policy prospective, Lexis/Nexis is not part of Mead's unitary paper business so that for that reason no nexus exists between Illinois and the gain on the liquidation of Mead's ownership of

> Lexis/Nexis to justify the Department's apportionment of the gain.

App. 71a. (Mead being Petitioner.)

Professor Ferdinand P. Schoettle, also renowned in the state and local tax community, testified and provided a report as an expert witness in economics. App. 78a-103a. With regard to any operational relationship that might have existed between Petitioner and Lexis/Nexis, Professor Schoettle opined in his report:

> As to the relationship between Mead and Lexis-Nexis, based upon my investigations I concluded that operational integration between Mead and Lexis-Nexis was virtually zero. Mead kept Lexis-Nexis as a separate business, an investment in a very different business than its own. That separateness was the reason Mead sold Lexis-Nexis. Mead had neither publishing nor computer expertise nor any other line function which it could integrate with Lexis-Nexis. Given these conditions, Lexis-Nexis was truly a "stand alone" company.

App. 93a. (Mead being Petitioner.)

The Circuit Court of Cook County found that Petitioner and Lexis/Nexis "were not functionally integrated, there was no centralization of management and no significant economies of scale between the two businesses." App. 39a. Based upon those findings the Circuit Court of Cook County concluded that, as a matter of law, Mead and Lexis/Nexis were not unitary. App. 39a. The Circuit Court of Cook County then found that the gain from Petitioner's sale of Lexis/Nexis was apportionable by

the State of Illinois because "Mead's investment in Lexis/Nexis did serve an operational purpose." App. 38a. Petitioner then filed an appeal with the Appellate Court of Illinois, First Judicial District, seeking reversal of the determination of the Circuit Court of Cook County.

The Appellate Court of Illinois, First Judicial District, concluded that Lexis/Nexis served an operational function for Petitioner.[1] App. 11a.

The Appellate Court of Illinois, First Judicial District, originally set forth these conclusions in an unpublished, non-precedential Rule 23 Order. Respondents then filed a Motion to Publish Rule 23 Order as Precedential Decision on November 14, 2006. App. 42a-47a. In this motion Respondents urged the Court to consider the importance of its decision as follows:

> *The decision provides such crucial guidance on a recurring issue* because it sets forth specific factors – such as on-going capital support, approval of major capital expenditures, manipulation of business organizations, and retaining benefits and control of excess cash – on which the Department, courts and taxpayers can rely in determining when a business unit qualifies as an operational asset and thus when the gain realized from its sale is constitutionally apportionable. *In addition, the decision is significant* because it approved of specific evidence on which the Department and courts can rely in making this determination – such as annual reports and federal 10-K statements – and disapproved of other evidence – the testimony of

[1] It did "not address the Department's claim of error as to the [Circuit Court's] 'lack of unitary business' finding." App. 11a.

> experts who offer opinions on matters of law – in deciding whether a business asset serves an operational function.

App. 45a (emphasis added).

Petitioner filed a Petition for Leave to Appeal with the Supreme Court of Illinois on December 8, 2006 with regard to the Appellate Court, First Judicial District's unpublished, non-precedential Rule 23 Order. The opinion of the Appellate Court of Illinois, First Judicial District (the precedential opinion issued in response to Respondent's motion), was issued on January 12, 2007 ("Illinois Decision"). App. 1a-22a. The Petition for Leave to Appeal was denied by the Supreme Court of Illinois on January 24, 2007. App. 41a.

REASONS FOR GRANTING THE PETITION

I. WITHOUT FURTHER REVIEW, THE ILLINOIS DECISION WILL EFFECTIVELY OVERTURN THE OPERATIONAL TEST SET FORTH IN *ALLIED-SIGNAL*

In *Allied-Signal* this Court held that even if two businesses operate on a non-unitary basis, a non-domiciliary state may still apportion the income from the disposal of one business if that business served an operational rather than an investment function. *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 787 (1992). Furthermore, this Court discussed the differences between an asset with an operational purpose and an asset with an investment purpose. The focal point of this Court's analysis for the finding of an operational relationship has been whether the asset was utilized

directly in the selling company's business, or was utilized as a short-term investment to fund the day-to-day operations of the selling company.

In this case, the trial court held that Petitioner and Lexis/Nexis were *not* unitary. Then, contrary to this Court's precedent, and without foundation, the trial court held and the appellate court affirmed the finding that Petitioner's investment in Lexis/Nexis was "operational."

The inquiry should not have ended with a determination that Lexis/Nexis was 100% owned by Petitioner nor should it have considered the other factors directly flowing from the 100% ownership (*i.e.*, Petitioner's capital investment in the early years of Lexis/Nexis, Petitioner's receipt of the benefit of certain tax advantages, Petitioner's investment of Lexis/Nexis' excess cash (for the benefit of Lexis/Nexis), Petitioner's approval of major debt and major capital expenditures, Petitioner's ability to change Lexis/Nexis from a division to a subsidiary and Petitioner's inclusion of Lexis/Nexis in describing the company's business in annual reports and Forms 10-K). Not only has this Court never even implied that any of these factors are to be considered in reaching a determination on the operational nature of an asset, but this Court has held that many of these factors are not indicative of whether a certain item of income may be apportioned to a non-domiciliary state.

The Illinois Decision improperly points to the fact that Petitioner owned 100% of Lexis/Nexis. In *F.W. Woolworth Co. v. Taxation & Revenue Department of New Mexico*, 458 U.S. 354, 356-57 (1982), however, this Court found that Woolworth and its subsidiaries were not part of a unitary business, even where three of the subsidiaries were wholly

owned. Moreover, in the context of a unitary business and in finding that the income received by Woolworth from the subsidiaries was not apportionable, the Court held that the mere potential to operate a subsidiary as part of a unitary business is insufficient for allowing the apportionment of income by a non-domiciliary state. *Id.* at 362 ("the *potential* to operate a company as part of a unitary business is not dispositive when, looking at 'the "underlying economic realities of a unitary business,'" the dividend income from the subsidiaries *in fact* is '[derived] from "unrelated business activity" which constitutes a "discrete business enterprise"'" (citations omitted)); *see also ASARCO Inc. v. Idaho State Tax Comm'n,* 458 U.S. 307, 323 (1982) ("Although ASARCO has the control potential to manage [the subsidiary], no claim is made that it has done so.").

The Illinois Decision improperly points to Petitioner's capital investment in the early years of Lexis/Nexis. *Woolworth*, 458 U.S. at 366 n.14 (where previous capital contributions did not lead to the apportionment of income by New Mexico).

The Illinois Decision also points to Petitioner's receipt of certain tax advantages, Petitioner's investment of Lexis/Nexis' excess cash (for the benefit of Lexis/Nexis), Petitioner's ability to change Lexis/Nexis from a division to a subsidiary and Petitioner's inclusion of Lexis/Nexis in describing the company's business in annual reports and Forms 10-K as bases for finding an operational relationship. These factors, however, will be present in any relationship between a parent company and a 100% owned business. Therefore the inescapable result of the Illinois Decision is that in Illinois, and in any other state that

decides to follow the holding, the operational requirement of *Allied-Signal* no longer exists.

Furthermore, this Court has held that for the continued vitality of the unitary principle, it cannot be that all income earned by a corporation is apportionable income:

> [t]he business of a corporation requires that it earn money to continue operations and to provide a return on its invested capital. Consequently all of its operations, including any investment made, in some sense can be said to be "for purposes related to or contributing to the [corporation's] business."

ASARCO, 458 U.S. at 326 (emphasis and citation omitted).

To allow the Illinois Decision to stand would be a violation of this principle in that in every situation where a parent owned 100% of a subsidiary or a division, all income from that business would be classified as apportionable income, regardless of the factual circumstances.

With regard to Petitioner's investment of excess cash on behalf of Lexis/Nexis, this Court in *Woolworth* noted that considering this commingling of funds to be determinative of the issue of the existence of a unitary relationship "subverts the unitary-business limitation. *All* dividend income – irrespective of whether it is generated by a 'discrete business enterprise,' – would become part of a unitary business if the test were whether the corporation commingled dividends from other corporations, whether subsidiaries or not." 458 U.S. at 364 n.11 (citation omitted). Furthermore, with regard to all of these issues this Court noted that consolidated accounting and

consolidated statements did not lead to a conclusion that [illegible]ted a unitary relationship. *Id.* at 369 n.22. *See also Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992) (in holding that a gain was not apportionable, this Court ignored descriptions of business activities in annual reports that the Supreme Court of New Jersey had relied upon in reaching the opposite conclusion).

The Illinois Decision also relied upon the fact that Petitioner continued to approve major capital expenditures. This action, however, amounts to nothing more than actions any good investor would take with regard to an investment. *Woolworth*, 458 U.S. at 369 (in concluding a unitary business did not exist the Court found that "[e]xcept for the type of occasional oversight – with respect to capital structure, major debt, and dividends – that any parent gives to an investment in a subsidiary, there is little or no integration of the business activities or centralization of the management").

The Illinois Decision did not address the two determinative focal points of this Court's previous discussions of the operational test – whether the asset was utilized directly in the selling company's business, or whether the asset was utilized as a short-term investment to fund the day-to-day operations of the selling company. *E.g.*, *Allied-Signal,* 504 U.S. at 789-90 ("Nor can it be maintained that Bendix's shares of ASARCO stock, which it held for over two years, amounted to a short-term investment of working capital analogous to a bank account or certificate of deposit."); *Corn Prods. Refining Co. v. Commissioner*, 350 U.S. 46, 50 (1955) (corn futures were vitally important to a corn products business as a guarantee against increases in the prices of raw corn).

Several other cases discuss an operational versus investment function in the context of determining the apportionability of income to a non-domiciliary state. The focus of all of these discussions is whether the asset was used in the same line of business as the company that sold it or whether the asset was analogous to working capital. None of the factors relied upon in the Illinois Decision are factors to be considered in deciding whether an asset serves an operational or investment function. *See Woolworth*, 458 U.S. at 370 ("In this case the parent company's operations are not interrelated with those of its subsidiaries so that one's 'stable' operation is important to the other's 'full utilization' of capacity." (citations omitted)); *Allied-Signal*, 504 U.S. at 789 (explains the holding in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983) by saying that a unitary relationship is shown where the management role of the parent "is grounded in its own operational expertise and operational strategy").

Petitioner's ownership of Lexis/Nexis, which lasted almost 26 years, served an investment function. Lexis/Nexis was acquired as an investment, and its management was separate from Petitioner's. Like Bendix's ownership of ASARCO, Petitioner's ownership of Lexis/Nexis did not amount to "a short-term investment of working capital." *Allied-Signal,* 504 U.S. at 790. Furthermore, unlike the facts in *Container Corp.* and *Corn Products*, Petitioner and Lexis/Nexis were in two completely separate and independent lines of business.

As noted by Illinois in its Motion to Publish Rule 23 Order as Precedential Decision before the Appellate Court of Illinois:

> The decision provides such crucial guidance on a recurring issue because it sets forth specific factors – such as on-going capital support, approval of major capital expenditures, manipulation of business organizations, and retaining benefits and control of excess cash – on which the Department, courts and taxpayers can rely in determining when a business unit qualifies as an operational asset and thus when the gain realized from its sale is constitutionally apportionable. In addition, the decision is significant because it approved of specific evidence on which the Department and courts can rely in making this determination – such as annual reports and federal 10-K statements – and disapproved of other evidence – the testimony of experts who offer opinions on matters of law – in deciding whether a business asset serves an operational function.

App. 45a.

Petitioner could not agree more that this incorrect decision will have a major effect on tax administration not only in Illinois, but in every state. The detrimental effect of this decision will impact every multi-state taxpayer. This Court's intervention is required to ensure that multi-state taxpayers and state taxing authorities alike receive a correct and uniform analysis in the determination of whether an asset serves an operational function or an investment function.

To let the Illinois Decision stand would be to decide that in any situation where a non-domiciliary business owns 100% of a subsidiary or division, all income from such subsidiary or division is apportionable by Illinois. This

would render the operational requirement of *Allied-Signal* meaningless.

II. WITHOUT FURTHER REVIEW, THE ILLINOIS DECISION, WHICH DECIDES AN IMPORTANT FEDERAL QUESTION, WILL STAND IN CONFLICT WITH DECISIONS OF OTHER STATE COURTS OF LAST RESORT

The Supreme Court of Minnesota dealt with the issue of whether an asset served an operational or investment function as follows:

> *Allied-Signal* stated that an assessment of whether an intangible asset served an operational function must focus "on the objective characteristics of the asset's use and its relation to the taxpayer and its activities in the taxing state." The Court gave us two examples of how an intangible might serve an operational function: a short term investment analogous to a bank account or certificate of deposit, or, under its decision in *Corn Products Refining Co. v. Commissioner*, a long-term investment in commodity futures that ensures a certain supply of a necessary product at a fixed price.
>
> As we discussed above, however, there is no evidence that Hercules treated its investment in Himont as a repository for working capital like a bank account or certificate of deposit. Nor did Hercules hold its Himont stock as a hedge against a fluctuating supply of polypropylene.

Hercules Inc. v. Commissioner of Revenue, 575 N.W.2d 111, 117 (Minn. 1998) (citations omitted).

The state's highest court in Maryland, the Court of Appeals, reached the same conclusion based upon a similar analysis in a case involving the same taxpayer and the gain from the sale of the same intangible asset. *Hercules Inc. v. Comptroller of Treasury*, 716 A.2d 276 (Md. 1998).

Neither of the courts of last resort in Minnesota or Maryland relied upon any of the factors relied upon in the Illinois Decision. While the Illinois Decision focuses solely on the potential control (*i.e.*, the 100% ownership of Lexis/Nexis by Petitioner and the factors flowing from such ownership) to support the conclusion that Lexis/Nexis served an operational function for Petitioner, the Court of Appeals of Maryland specifically rejected an argument made by the state regarding ownership and explained that pursuant to *Woolworth* the test for apportionability of the gain "was not the *potential* of unitary control, but rather the actual, in fact unitariness or separateness of the subsidiary enterprises." *Hercules*, 716 A.2d at 281. The Illinois Decision is in direct conflict with the decision of the Court of Appeals of Maryland in *Hercules*.

The Supreme Court of Alaska in *Alaska Department of Revenue v. OSG Bulk Ships, Inc.*, 961 P.2d 399 (Alaska 1998), reviewed the conclusion of a hearing officer that an asset had served an operational function. The hearing officer had based that conclusion on his finding (for which he relied heavily upon the statements in the company's annual reports) that the company's "'investment decisions were obviously aimed at building its financial strength overall.'" *Id.* at 413-14. The Supreme Court of Alaska found that "the hearing officer's definition of 'operational income' would swallow the distinction between operational

and investment income," in that all business decisions are made with the goal of profitability. *Id.* at 414. Indeed, the court noted that this Court had specifically rejected New Jersey's argument in *Allied-Signal* that any distinction between operational and investment income was artificial. *Id.* The Supreme Court of Alaska reversed the determination of the hearing officer, but remanded the matter for further proceedings with the instructions that the income from the asset could be apportioned by Alaska only if the asset were part of the company's unitary business, or the asset was a short term investment used to fund the day-to-day operations of the company that was similar to a bank account. *Id.* Again, the Illinois Decision, relying upon factors such as Petitioner's capital investment in Lexis/Nexis, its receipts of certain tax advantages, its approval of major debt and capital expenditures and the inclusion of Lexis/Nexis in its annual reports and Forms 10-K, is in direct conflict with this decision of the Supreme Court of Alaska.

Several other state courts of last resort have reached decisions similar to those of Alaska, Maryland and Minnesota. *Pennzoil Co. v. Department of Revenue*, 33 P.3d 314, 318 (Or. 2001) (In finding an operational relationship the Supreme Court of Oregon found: "The acquisition of oil reserves is related – indeed it is vitally important – to the continued blending and distribution of motor oil in Oregon."), *cert. denied*, 535 U.S. 927 (2002); *Hoechst Celanese Corp. v. Franchise Tax Bd.*, 22 P.3d 324, 345 (Cal.) (In finding a pension plan and trust used to retain employees and attract new employees was related operationally to the taxpayer's business the Supreme Court of California stated: "Although the United States Supreme Court has not clearly differentiated operational

and investment functions, it has stated that an asset serves an operational function if it helps the taxpayer 'make better use . . . of [its] existing business-related resources.'" (citation omitted)), *cert. denied*, 534 U.S. 1040 (2001).

Thus the state courts of last resort that have dealt with the issue of determining whether an asset served an operational or investment function, have asked the questions – is the asset directly related to the business of the company that disposed of the asset, or is the asset a short-term investment similar to working capital. These questions are consistent with the decisions of this Court. Illinois now seeks to ignore these factors and to, instead, focus on other factors, most of which are not recognized as relevant to a determination of whether or not income is apportionable.

The Illinois Decision is in direct conflict with the decisions of the courts of last resort of other states and, if allowed to stand, will have a major effect on tax administration not only in Illinois, but in every state that imposes an income tax. This Court's intervention is required to ensure that multi-state taxpayers and state taxing authorities alike receive a correct and uniform analysis in the determination of whether an asset serves an operational or investment function.

CONCLUSION

The Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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Dated: April 20, 2007

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APPENDIX A

SIXTH DIVISION January 12, 2007

No. 1-03-1160

THE MEAD CORPORATION, an Ohio Corporation, Plaintiff-Appellant,	) Appeal from the) Circuit Court of) Cook County
v.	)
THE DEPARTMENT OF REVENUE, GLEN L. BOWER, Director of the Department of Revenue, and JUDITH BAAR TOPINKA, Treasurer of the State of Illinois, Defendants-Appellees.	) No. 00 CH 7854) Honorable) Alexander P. White,) Judge Presiding.

PRESIDING JUSTICE FITZGERALD SMITH delivered the opinion of the court:

Plaintiff Mead Corporation, an Ohio corporation (Mead or plaintiff), appeals three orders of the circuit court concerning the classification and calculation of sales gain reported on its 1994 Illinois tax return, granting judgment in favor of defendants Illinois Department of Revenue (Department), Glen L. Bower, Director of the Illinois Department of Revenue,[1] and Judith Baar Topinka, Treasurer of the State of Illinois (collectively, defendants). Mead filed a combined unitary Illinois income tax return for the 1994 tax year, including Mead Data Central, Inc., Lexis, Inc., and Nexis, Inc. (collectively, Lexis/Nexis), as members of its unitary business group, and including in

[1] Defendants note that the current Director, Brian Hamer, may be substituted for Bower, who is the former Director.

its Illinois combined apportionable business income the 1994 income earned by Lexis/Nexis, but excluding the gain of more than $1 billion from the sale of Lexis/Nexis that year. Mead also included its gross receipts from the sale of interest-bearing financial instruments in its sales factor denominator of the combined apportionment formula. The Department determined that the Lexis/Nexis sale gain constituted apportionable business income and the net income, rather than the gross receipts from the sale of the financial instruments, be used to compute Mead's sales factor denominator. After the Department issued notices of deficiencies for more than $4 million in income tax and interest, which Mead paid under protest, Mead challenged the Department's classification of the sales gain as apportionable business income and its calculation of the sales factor denominator. We affirm.

This case presents a voluminous record. However, the facts, as set forth below, are essentially undisputed.

Mead is an Ohio corporation which transacts business in Illinois. In 1968, when Mead was a producer and seller of paper, packaging, and school and office supplies, it purchased Data Corporation for $6 million. At the time, Data Corporation was developing, among other things, ink jet printing technologies and a computerized full text information retrieval system. The latter, by 1973, evolved into Lexis/Nexis. Over the years, Mead made capital contributions to Lexis/Nexis, which become profitable only by the end of the 1970s.

During its ownership of Lexis/Nexis, Mead treated Lexis/Nexis variously as a corporate division or as a subsidiary. In 1980, Lexis/Nexis was merged into Mead as a division; in 1985, Lexis/Nexis was reincorporated separately. In

December 1993, Mead and Lexis/Nexis merged again, with Lexis/Nexis again becoming a division of the parent company. During the years of ownership, Mead continued to approve major capital expenditures for Lexis/Nexis, including a 1984 expansion of the Lexis/Nexis computer center and central processing units. In 1993, at the time of the second merger, Mead's board of directors approved a capital expenditure of nearly $13 million for the improvement of Lexis/Nexis' search system. Again, the following year, the Mead board approved significant expenditures for Lexis/Nexis.

Mead and Lexis/Nexis maintained separate day-to-day business operations, and they did not share personnel or make joint purchases. Since 1980, Lexis/Nexis had its own building about 15 miles from Mead's Dayton headquarters. There was no centralized manufacturing or warehousing of products, and Mead and Lexis/Nexis were described as having different corporate cultures. There were no favorable intercompany transactions. However, Mead made nightly a cash sweep of Lexis/Nexis bank accounts, investing the funds with benefits accruing to Lexis/Nexis, but in a manner decided by Mead.

Since 1988, the Department had asserted that Mead and Lexis/Nexis were a unitary business. Although Mead disagreed, to settle disputed audit findings, Mead included Lexis/Nexis in its unitary business group from 1988 through 1994. According to Mead's 1993 annual report, Mead was not only "one of the world's largest manufacturers of paper," and a leader in packaging, but it was "the developer of the world's leading electronic information retrieval services for law, patents, accounting, finance, news and business information." Lexis/Nexis was included as one of Mead's business segments, but not in Mead's

discussion of its "investees." Mead filed a 10-K form with the Securities and Exchange Commission (SEC) for the year ending December 31, 1993, in which Mead described itself as a company engaged in the manufacture and sale of paper and wood products, and school and office supplies, and engaged in electronic publishing.

In May 1994, Mead announced its plan to sell Lexis/Nexis, stating in its press release that it had "grown" Lexis/Nexis "since 1968 from a small legal database into the world's premier provider of online legal information and the pioneer in computer-assisted news retrieval." On December 2, 1994, Mead sold the assets of Lexis/Nexis to Reed Elsevier, plc, for approximately $1.5 billion. In describing the divestiture in its 1994 annual report, Mead again stated that had "grow[n] this business" but decided to use approximately $350,000 of the gain to buy back stock. Mead also used the proceeds to reduce its short- and long-term debt levels.

For the 1994 tax year, Mead and its subsidiaries filed an Illinois combined unitary income tax return, in which it listed Lexis/Nexis as a unitary subsidiary, as it had done from 1988-93. Mead reported its base income as $1,074,709,139 and its Illinois sales in 1994 as $338,309,666, of which Lexis/Nexis contributed $46,912,518. Mead reported as nonbusiness income $1,056,001,948 in gain from the sale of its Lexis/Nexis division. The reported nonbusiness income was a gain on "goodwill" realized from the Lexis/Nexis sale. Mead also included Lexis/Nexis' assets in its Illinois apportionment factors on its 1994 Illinois return. Mead included in its computation of the denominator of the sales apportionment factor $4,846,382,229 as gross receipts from the sale of financial instruments, of

which $1,967,953.61 was interest income earned by those investments.

The Department audited Mead's Illinois income tax returns for the 1993 and 1994 tax years and issued two notices of deficiencies for the 1994 tax year. The deficiency notices resulted from two audit findings: (1) the $1,056,001,948 gain from the Lexis/Nexis sale was improperly classified as nonbusiness income and (2) Mead could include only the $1,967,953.61 that was interest income in its sales factor denominator rather than the $4,846,382,229 gross receipts from the sale of financial instruments. The Department found that Mead owed $3,149,222 in Illinois income tax and $1,049,017 in interest.

Mead protested, but paid the amount into the protest fund (see 30 ILCS 230/1 *et seq.* (West 2002)). In January 2001, Mead filed an amended verified complaint, seeking injunctive and declaratory relief. In the amended complaint, Mead challenged the Department's classification of the gain from the Lexis/Nexis sale as apportionable business income and the Department's calculation of its sales factor denominator.

In March 2002, proceedings on the former issue, which included the testimony of numerous witnesses, were held before the circuit court, while the latter issue was decided on the parties' cross-motions for partial summary judgment. As to the latter issue, the computation of the sales factor, the circuit court initially granted Mead's motion, and the Department filed a motion for reconsideration. On December 2, 2002, the court issued a memorandum decision, judgment and order, reversing the partial summary judgment in Mead's favor, denying

Mead's motion for partial summary judgment, and granting the Department's motion for the same.

On March 18, 2003, the court issued a memorandum decision, judgment and order deciding the classification issue. In its order, the court found, among other things, that Mead and Lexis/Nexis were not unitary, the sale of Lexis/Nexis represented a liquidation in the business of electronic publishing, and, because the property disposed of in the liquidation was "essential to the taxpayer's regular trade or operations," the gain therefrom was apportionable business income.

On March 25, 2003, the court issued a final judgment order, finding that all issues in plaintiff's first amended verified complaint had been resolved in favor of defendants (based on the findings of fact and conclusions of law set forth in the orders of December 2, 2002, and March 18, 2003) and that no remand to the Department was necessary. The court dissolved preliminary injunctions that had been entered in 1999 and 2001, ordered judgment to be entered in defendants' favor in the amount of $4,238,221, representing the 1999 and 2000 payments by plaintiff made under protest, ordered the State Treasurer to transfer the protest payments from the protest fund to the appropriate state fund, and stated that the order represented a complete disposition of all issues.

Mead appeals from the December 2, 2002, and March 18 and 25, 2003, orders.

On appeal, Mead first contends that the gain from the 1994 sale of Lexis/Nexis should be allocated rather than classified as apportionable Illinois income.

Initially, we note that the parties appear to agree on the standard of review. Both agree that the circuit court heard substantial testimony and considered documents and stipulated facts, but that, for the most part, the facts of this case were undisputed. The parties further recognize that, where the fact finder examines the legal effect of a given set of facts, it decides a mixed question of law and fact which is subject to an intermediate standard of review. See *Carpetland U.S.A., Inc. v. Illinois Department of Employment Security,* 201 Ill. 2d 351, 369, 776 N.E.2d 166 (2002); *City of Belvidere v. Illinois State Labor Relations Board,* 181 Ill. 2d 191, 205, 692 N.E.2d 295 (1998). Under such circumstances, the decision is based on fact-finding that is inseparable from the application of law to fact and is reviewed under a clearly erroneous standard. *Carpetland U.S.A., Inc.,* 201 Ill. 2d at 369; see *AFM Messenger Service, Inc. v. Department of Employment Security,* 198 Ill. 2d 380, 391, 763 N.E.2d 272 (2001). This standard is largely deferential to the decision maker. *AFM Messenger Service, Inc.,* 198 Ill. 2d at 395; *Zebra Technologies Corp. v. Topinka,* 344 Ill. App. 3d 474, 480, 799 N.E.2d 725 (2003).

Under the clearly erroneous standard, a finding of the lower court may be reversed only if, after careful review of the entire record in light of the applicable rule of law, the reviewing court is left with the "'definite and firm conviction'" that the finding is in error. *Carpetland U.S.A., Inc.,* 201 Ill. 2d at 369, quoting *AFM Messenger Service, Inc.,* 198 Ill. 2d at 395; *Zebra Technologies Corp.,* 344 Ill. App. 3d at 481. Purely factual findings are entitled to deference and are reversed only if they are contrary to the manifest weight of the evidence (*Carpetland U.S.A., Inc.,* 201 Ill. 2d at 369; *Zebra Technologies Corp.,* 344 Ill. App. 3d at 480),

while pure questions of law are reviewed *de novo (Carpetland U.S.A., Inc.,* 201 Ill. 2d at 369; *Zebra Technologies Corp.,* 344 Ill. App. 3d at 480), giving deference to the Department's interpretation of its governing statutes and its regulations (see *Automatic Data Processing, Inc. v. Department of Revenue,* 313 Ill. App. 3d 433, 443-44, 729 N.E.2d 433 (2000)).

The Illinois Income Tax Act (Act) provides that a corporate taxpayer conducting a multistate business in Illinois use the formula apportionment method of taxation. 35 ILCS 5/304(a) (West 2002)[2]; *Automatic Data Processing, Inc.,* 313 Ill. App. 3d at 438-39. Under the formula set forth in section 304(a), three factors, which are calculated in fractions, were used to apportion income: Illinois property in proportion to all property; Illinois payroll in proportion to all payroll; and Illinois sales in proportion to all sales. 35 ILCS 5/304(a) (West 2002); *Automatic Data Processing, Inc.,* 313 Ill. App. 3d at 439. The sales factor was double weighted. 35 ILCS 5/304(a) (West 2002); *Automatic Data Processing, Inc.,* 313 Ill. App. 3d at 439.

The Act defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business," which includes "income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business." 35 ILCS 5/1501(a)(1) (West 2002); see also *Texaco-Cities Service Pipeline Co. v. McGaw,* 182 Ill. 2d 262, 267, 695

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[2] The Department notes that, starting in 1999, a single factor apportionment method based solely on sales has been applied. See 35 ILCS 5/304(h), 1501(a)(27) (West 2002).

N.E.2d 481 (1998). Because all of a business's income is presumed to be "business income" (see *Borden, Inc. v. Department of Revenue,* 295 Ill. App. 3d 1001, 1010, 692 N.E.2d 1335 (1998)), an "entity claiming that its income is nonbusiness income bears the burden of clearly proving this fact" (*Texaco-Cities,* 182 Ill. 2d at 268).

Mead contends that the income from the Lexis/Nexis sale was nonbusiness income, subject to allocation rather than apportionment, and that apportionment was unconstitutional. The Department counters that apportionment here passes constitutional muster because the requisite nexus to Illinois and rational relationship to Mead's business activities in Illinois existed. We agree.

Under the United States Constitution, the taxpayer must have "'some minimum connection'" to the taxing body and the tax must be "'rationally related to "values connected with the taxing [s]tate."'" *Hercules, Inc. v. Department of Revenue,* 324 Ill. App. 3d 329, 335, 753 N.E.2d 418 (2001), quoting *Quill Corp. v. North Dakota,* 504 U.S. 298, 306, 119 L. Ed. 2d 91, 102, 112 S. Ct. 1904, 1909-10 (1992), quoting *Moorman Manufacturing Co. v. Bair,* 437 U.S. 267, 273, 57 L. Ed. 2d 197, 204, 98 S. Ct. 2340, 2344 (1978). The due process and commerce clauses of the United States Constitution prohibit a state from taxing value earned "outside its borders" (*Home Interiors & Gifts, Inc. v. Department of Revenue,* 318 Ill. App. 3d 205, 210, 741 N.E.2d 998 (2000), citing *Allied-Signal, Inc. v. Director, Division of Taxation,* 504 U.S. 768, 119 L. Ed. 2d 533, 112 S. Ct. 2251 (1992); *Hormel Foods Corp. v. Zehnder,* 316 Ill. App. 3d 1200, 1203, 738 N.E.2d 145 (2000)), but instead require that there be "'"some definite link, some minimum connection, between a state and the * * * transaction it seeks to tax"'" (*Hercules, Inc.,* 324

Ill. App. 3d at 336, quoting *Quill Corp.*, 504 U.S. at 306, 119 L. Ed. 2d at 102, 112 S. Ct. at 1909, quoting *Miller Brothers Co. v. Maryland,* 347 U.S. 340, 344-45, 98 L. Ed. 744, 748, 74 S. Ct. 535, 539 (1954)). States are permitted, however, to tax the multistate income of a nondomiciliary corporation where such minimal connection exists between the taxing state and the corporation's business activities and where a rational relationship exists between "'the income attributed to the taxing State and the intrastate value of the corporate business.'" *Hercules, Inc.,* 324 Ill. App. 3d at 336, quoting *Allied-Signal, Inc.,* 504 U.S. at 772, 119 L. Ed. 2d at 542, 112 S. Ct. at 2255. Further, the taxpayer has "'the distinct burden of showing by clear and cogent evidence that [the state tax] results' in the taxation of 'extraterritorial values.'" *Hercules, Inc.,* 324 Ill. App. 3d at 336, quoting *Container Corp. of America v. Franchise Tax Board,* 463 U.S. 159, 164, 77 L. Ed. 2d 545, 554, 103 S. Ct. 2933, 2939 (1983).

A state's apportionment of income of a multistate nondomiciliary corporation from a capital or nontangible transaction is constitutional in two circumstances: where there is a unitary business relationship between the payor and the payee or where the intangible asset served an operational rather than an investment function. *Hercules, Inc.,* 324 Ill. App. 3d at 336; see also *Allied-Signal, Inc.,* 504 U.S. at 787, 119 L. Ed. 2d at 552, 112 S. Ct. at 2263. Under the unitary relationship test, a single state may tax all the income earned and apportioned, even where a business has subsidiaries, divisions, or common ownership of other businesses that operate in different jurisdictions, if the businesses have common managerial or operational resources that "produce economies of scale and a substantial sharing of values." *Hercules, Inc.,* 324 Ill. App. 3d at

336; see also *Container Corp. of America,* 463 U.S. at 179, 77 L. Ed. 2d at 562, 103 S. Ct. at 2947.

Under the operational function test, even where no unitary relationship exists, a state may apportion income when the capital transaction serves an operational function rather than an investment function. *Hercules, Inc.,* 324 Ill. App. 3d at 337, see also *Allied-Signal, Inc.,* 504 U.S. at 787, 119 L. Ed. 2d at 552, 112 S. Ct. at 2263. There, the relevant inquiry focuses on the "'objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State.'" *Hercules, Inc.,* 324 Ill. App. 3d at 337, quoting *Allied-Signal, Inc.,* 504 U.S. at 785, 119 L. Ed. 2d at 550, 112 S. Ct. at 2262.

Mead does not dispute that Lexis/Nexis had the requisite connection, or nexus, with Illinois. Rather, it contends that taxation of the intangible income, including the gain on goodwill, from the Lexis/Nexis sale was unconstitutional because Mead and Lexis/Nexis were not unitary (as the circuit court found) and because its ownership of Lexis/Nexis did not serve an operational function, but merely an investment function. In response, the Department argues that the court erred by finding there was no unitary relationship and that, in any event, Mead failed its burden of proving that Lexis/Nexis was not an operational asset. Because we agree with the latter contention, we do not address the Department's claim of error as to the "lack of unitary business" finding.

Here, among its findings of contested facts, the circuit court found that Mead's investment in Lexis/Nexis "did serve an operational purpose, in that Lexis/Nexis represented a significant business segment of Mead." The court recognized that although, according to testimony of two of

Mead's witnesses, there was no functional integration of the companies, the court also found it was "not clear that there was no operational purpose." For that conclusion, the court relied upon the fact that Mead considered Lexis/Nexis in its strategic planning, particularly in the allocation of its resources. It concluded that the "operational purpose allowed Mead to limit the growth of Lexis/Nexis if only to limit its ability to expand or to contract through its control of capital investment."

In its challenge to that finding, Mead relies almost exclusively upon *Hercules, Inc.* and *ASARCO Inc. v. Idaho State Tax Comm'n,* 458 U.S. 307, 73 L. Ed. 2d 787, 102 S. Ct. 3103 (1982), which is cited therein. In *Hercules, Inc.,* the court reversed a decision that all capital gains from a second corporation owned by the plaintiff corporation constituted apportionable business income because the court determined there was no operational purpose in the plaintiff corporation's investment in the second corporation. *Hercules, Inc.,* 324 Ill. App. 3d at 343-44. However, the facts of *Hercules, Inc.* are readily distinguishable from those in the instant case. There, gain at issue resulted from the plaintiff Hercules Corporation's sale of its minority stake in Himont, which had been formed by Hercules in a joint venture with a foreign corporation. The court rejected the argument that Hercules' investment in Himont served an operational purpose, based in part on Himont's "stand alone" status. *Hercules, Inc.,* 324 Ill. App. 3d at 338. Hercules never owned a majority share of Himont and it did not exercise management control over Himont.

Here, in contrast to Hercules' minority (38.7%) ownership and lack of management control over its subsidiary corporation, Mead was 100% owner of Lexis/Nexis.

Although Mead did not have day-to-day control over Lexis/Nexis, its involvement with Lexis/Nexis was more than merely passive. Mead developed Lexis/Nexis by contributing capital support until it become profitable. Further, Mead continued to approve major capital expenditures by Lexis/Nexis. It also manipulated Lexis/Nexis' business organization, treating it as either a division or a corporate subsidiary, depending on what was more beneficial to Mead. Additionally, Mead retained tax benefits and control over Lexis/Nexis' excess cash.

Moreover, in its own 1993 annual report, Mead identified itself as "the developer of the world's leading electronic information retrieval services for law, patents, accounting, finance, news and business information"; likewise, in its 1993 10-K form, Mead described itself as engaged in electronic publishing and included Lexis/Nexis in its discussion of business segments rather than its "investees." Compare *Allied-Signal, Inc.*, 504 U.S. at 788, 119 L. Ed. 2d at 552, 112 S. Ct. at 2263 (company's 20.6% ownership of subsidiary's stock did not establish operational relationship); *ASARCO Inc.*, 458 U.S. at 321-22, 73 L. Ed. 2d at 798-99, 102 S. Ct. at 3111-12 (bare majority ownership of stock not enough to show operational relationship in light of lack of ability to control subsidiary).

Mead also relies heavily in its challenge to the court's finding of operational purpose upon its assertion that the court improperly considered the annual report and the 10-K form in making that finding. However, Mead presents no relevant legal authority to support such assertion. Additionally, for the same point, Mead relies upon the testimony of its experts, particularly that of Dr. Ferdinand Schoettle, an economist, and Professor Richard Pomp, a tax law expert. However, experts may not testify with

respect to legal conclusions or give testimony amounting to statutory interpretations. *LID Associates v. Dolan,* 324 Ill. App. 3d 1047, 1058, 756 N.E.2d 866 (2001); *Coyne v. Robert H. Anderson & Associates, Inc.,* 215 Ill. App. 3d 104, 112, 574 N.E.2d 863 (1991). Therefore, Mead has not established that the court's finding of an operational purpose was against the manifest weight of the evidence (see *Zebra Technologies Corp.,* 344 Ill. App. 3d at 480), nor has it established as clearly erroneous the conclusion that the gain was nonbusiness income (see *Texaco-Cities,* 182 Ill. 2d at 268).

Next, Mead contends the gain was nonbusiness income under *Blessing/White, Inc. v. Zehnder,* 329 Ill. App. 3d 714, 768 N.E.2d 332 (2002), because it resulted from the liquidation of an entire line of business. The Department responds that Mead did not prove that the gain was not business income.[3] We agree.

As previously set forth, the Act defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business," which includes "income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business." 35 ILCS 5/1501(a)(1) (West

[3] We note the Department's citation, as supplemental authority, of the 2004 amendment of the definition of business income in section 1501(a)(1), to now read that "the term 'business income' means all income that may be treated as apportionable business income under the Constitution of the United States." 35 ILCS 5/1501(a)(1) (West 2004). The Department contends that the amendment eliminated the language in section 1501(a)(1) that was relied upon in *Blessing/White, Inc.* to recognize the business liquidation exception to the functional test for business income.

2002). Two tests, corresponding to the two clauses in section 1501(a)(1), are applied to determine if income from the disposition of a capital asset is "business income." See *Texaco-Cities Service Pipeline Co.*, 182 Ill. 2d at 268. Under the first, the "transactional test," if the income is "'attributable to a type of business transaction in which [the] taxpayer regularly engages,'" it is business income. *Texaco-Cities Service Pipeline Co.*, 182 Ill. 2d at 269, quoting *National Realty & Investment Co. v. Department of Revenue*, 144 Ill. App. 3d 541, 554, 494 N.E.2d 924 (1986). Under the second test, the "functional test," all gain from the disposition of a capital asset is considered business income if the asset disposed of was "'used by the taxpayer in its regular trade or business operations.'" *Texaco-Cities Service Pipeline Co.*, 182 Ill. 2d at 269, quoting *National Realty & Investment Co.*, 144 Ill. App. 3d at 554

In the instant case, while Mead asserts that the gain did not satisfy either the transactional or the functional test, the conclusion reached as to the former test is undisputed. Therefore, we do not consider the transactional test, but only the functional test. Mead claims that the gain qualifies as nonbusiness income under a "modified" form of the functional test set forth in *Blessing/White Inc.*, 329 Ill. App. 3d 714.

There, the corporate taxpayer sold substantially all its assets, ceased doing business in Illinois, and distributed the proceeds to its individual shareholders. The court held that the functional test is satisfied in such cases only where the property and the liquidation of assets, *i.e.*, the disposition, are essential to the taxpayer's regular trade or operations. *Blessing/White, Inc.*, 329 Ill. App. 3d at 726. Further, the court found significant that the proceeds were "not used to support any ongoing business concerns but,

instead, disbursed in their entirety to the company's shareholders." *Blessing/White, Inc.*, 329 Ill. App. 3d at 728.[4]

Here, in contrast, there was no such disbursement to shareholders. Rather, Mead remained in business and reinvested the gain in its ongoing business. Mead paid federal taxes on the gain, then used about one-third of the proceeds to buy back stock and about two-thirds to reduce its debt level. While Mead argues that such actions increased the value of its shares, and thus benefitted its shareholders, we find such contention unpersuasive in this context. Mead reduced its debt levels and the company's long-term debt to capital ratio from 46% to 30.5%, and, using the Lexis/Nexis sale gain, increased its working capital to $807 million compared to $380 million the previous year. Further, unlike the Department's treatment of the taxpayer as two separate corporations under section 338(h)(10) of the Internal Revenue Code in *American States Insurance Co.*, 352 Ill. App. 3d at 531-32, the Department here claimed that Mead and Lexis/Nexis were unitary.

Mead also relies upon cases from foreign jurisdictions for its contention that the business liquidation exception should apply here. See, *e.g.*, *Lenox, Inc. v. Tolson*, 353 N.C. 659, 548 S.E.2d 513 (2001); *Laurel Pipe Line Co. v. Commonwealth*, 537 Pa. 205, 642 A.2d 472 (1994); *May*

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[4] The parties filed an agreed motion, which was granted, to cite as supplemental authority the decision, rendered after the briefs in this case were filed, in *American States Insurance Co. v. Hamer*, 352 Ill. App. 3d 521, 816 N.E.2d 659 (2004). In that case, the gain from the sale of a foreign corporation was properly treated as a deemed sale of assets, or nonbusiness income, rather than apportionable business income. *American States Insurance Co. v. Hamer*, 352 Ill. App. 3d at 532.

Department Stores Co. v. Indiana Department of State Revenue, 749 N.E.2d 651 (2001). For its part, the Department, recognizing its failure to raise such argument before the court below normally would result in waiver of the issue, nonetheless contends that *Blessing/White, Inc.* is contrary to Illinois law and provides inconsistent precedent with the "business liquidation exception" to the functional test for business income. On that basis, it asks this court to address that doctrine. However, having concluded that the Lexis/Nexis sale does not fall within the business liquidation exception, set forth in *Blessing/White, Inc.,* to the functional test for business income, we need not consider foreign authorities or address the validity of the business liquidation exception. Rather, because Mead reinvested the sale proceeds in its ongoing business, the court properly concluded that the gain satisfied the functional test and was properly identified as business income.

Finally, Mead contends that the inclusion of the Lexis/Nexis sale gain in its Illinois apportionable business income is unconstitutional because it is disproportionate to Mead's activities in Illinois. The Department responds that Mead never sought alternative apportionment (see 35 ILCS 5/304(f) (West 2002) (party seeking alternative apportionment must petition Director for it)) and that Mead has not proved by the clear and cogent evidence required that the income attributable to Illinois is "'out of all appropriate proportions to the business transacted'" in Illinois (*Container Corp. of America,* 463 U.S. at 170, 77 L. Ed. 2d at 556, 103 S. Ct. at 2942, quoting *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell,* 283 U.S. 123, 135, 75 L. Ed. 879, 908, 51 S. Ct. 385, 389 (1931)). We agree and note the Department's point that, in the case

upon which Mead relies almost exclusively, *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell,* 283 U.S. 123, 75 L. Ed. 879, 51 S. Ct. 385 (1931), a challenge to the three-factor formula (like the one used by the Department) was rejected by the United States Supreme Court, which held that such formula does not distort income attributable to the State. *Container Corp. of America,* 463 U.S. at 182-84, 77 L. Ed. 2d at 564-65, 103 S. Ct. at 2949-50 (no unconstitutional distortion even where combined apportionment converted net losses into substantial profits). See also *Pennzoil Co. v. Department of Revenue,* 332 Or. 542, 550 n.4, 33 P.3d 314, 318-19 n.4 (2001) (finding "*Hans Rees'* is of limited value" in the states using a multifactor apportionment).

Moreover, as the Department maintains, Mead did not establish that either it or Lexis/Nexis did not do substantial business in Illinois. As the Department notes, Mead's 1994 tax return indicates that the contrary is true: Mead reported Illinois sales of more than $338 million, of which over $46 million were attributable to Lexis/Nexis. Mead also relies upon a conclusion by its accounting expert, Kennion Yano, of distortion, but that testimony was considered by the circuit court, along with the auditor's criticism of Yano's evidence. The court ultimately struck Yano's conclusion. Mead has not proven clearly and cogently that the apportionment of the Lexis/Nexis gain was grossly disproportionate to its Illinois income or activities. For the reasons stated above, Mead has not established as clearly erroneous the court's conclusion that the gain from the sale of Lexis/Nexis was apportionable business income.

Mead also contends that the gross receipts from the sale of financial instruments should be included in the

calculation of its sales factor on its 1994 Illinois tax return.

This issue of whether the Department properly excluded from the sales factor denominator the $4.8 billion that Mead reported in gross receipts of financial instruments was decided on the parties' cross-motions for summary judgment. Accordingly, because the issue was resolved on motions for summary judgment, which is granted where the pleadings, depositions, admissions, and affidavits, if any, show that there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law, review is *de novo.* 735 ILCS 5/2-1005(c) (West 2002); *Arangold Corp. v. Zehnder,* 204 Ill. 2d 142, 146, 787 N.E.2d 786 (2003).

As previously noted, section 304 of the Act, which governs business income of persons other than residents, provides in subsection (a) an apportionment formula for corporations conducting business in Illinois. 35 ILCS 5/304(a) (West 2002). As set forth in section 304(a), one of the factors used in calculating this formula is the "sales factor," which is "a fraction, the numerator of which is the total of sales of the person in this State during the taxable year, and the denominator of which is the total sales of the person everywhere during the taxable year." 35 ILCS 5/304(a)(3)(A) (West 2002). Section 304 also explicitly allows for alternative allocation upon petition of either the taxpayer or the Director of the Department if the apportionment provisions "do not fairly represent the extent of [the taxpayer's] business activity in this State." 35 ILCS 5/304(f) (West 2002).

Mead relies on the definition in section 1501(a)(21) of the Act which states that "'sales' means all gross receipts

of the taxpayer not allocated under Sections 301, 302, and 303" (35 ILCS 5/1501(a)(21) (West 2002)) for its claim that the gross receipts from the sale of financial instruments should be included in the calculation of its sales factor on its 1994 Illinois tax return. Yet, section 1501 ("Definitions") provides generally that the stated definition applies "in this Act, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof" (35 ILCS 5/1501(a) (West 2002)), but, as noted, section 304, which addresses the "sales factor," explicitly allows for alternative allocation upon petition of either the taxpayer or the Director (35 ILCS 5/304(f) (West 2002)). Although "sales," then, may mean all gross receipts of the taxpayer that otherwise qualify as business income (see 35 ILCS 5/1501(a)(21) (West 2002)), under the standard apportionment formula, section 304 explicitly provides for modification of the apportionment provisions (35 ILCS 5/304(f) (West 2002)); therefore, we reject Mead's argument that the plain language of the statute requires the inclusion of the disputed gross receipts in the calculation of the sales factor.

Rather, in accordance with the authority granted by section 304(f), section 100.3380 of the Department's regulations was enacted. See 86 Ill. Adm. Code § 100.3380 (1996).[5] Section 100.3380(b)(6) provides special rules for computing the sales factor; one of those rules governs the sale of business intangibles and provides that "[i]n the case of sales of business intangibles * * * gross receipts

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[5] The Department notes that, in 2002, section 100.3380 was amended to state more explicitly that it was enacted in fulfillment of section 304(f) of the Act. See 26 Ill. Reg. 15304, 15314 (eff. October 9, 2002), codified, at 86 Ill. Adm. Code § 100.3380.

shall be disregarded and only the net gain (loss) therefrom shall be included in the sales factor." 86 Ill. Adm. Code § 100.3380(b)(6) (1996).

Mead asserts that the Department cannot "circumvent" the meaning of the statute by adopting a regulation. However, the Department has proper authority to make reasonable regulations, which have the force and effect of law. *Exhibits, Inc. v. Sweet,* 303 Ill. App. 3d 423, 427, 709 N.E.2d 236 (1998). The regulation, which is construed under the same standards governing the construction of statutes, is presumed to be valid, and the burden of establishing the regulation is unconstitutional is charged to the party challenging its validity. *Exhibits, Inc.,* 303 Ill. App. 3d at 427.

In its challenge to the validity of the regulation at issue, Mead relies primarily upon the testimony of its experts and a general principle concerning administrative rules. See *Canteen Corp. v. Department of Revenue,* 123 Ill. 2d 95, 108, 525 N.E.2d 73 (1988) (administrative rules can neither limit nor extend the scope of a statute).[6] While the Department questions the competency of the testimony of Mead's experts (see, *e.g., LID Associates,* 324 Ill. App. 3d at 1058), we do not find Mead's argument persuasive and, in any event, believe that section 304(f) of the Act and section 100.3380 were correctly applied here.

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[6] We note the additional foreign authority cited by the Department, including its supplemental authority, *Toys "R" Us, Inc. v. Franchise Tax Board,* 138 Cal. App. 4th 339, 41 Cal. Rptr. 3d 285 (2006), *Microsoft Corp. v. Franchise Tax Board,* 39 Cal. 4th 750, 139 P.3d 1169, 47 Cal. Rptr. 3d 216 (2006), and *General Motors Corp. v. Franchise Tax Board,* 39 Cal. 4th 773, 139 P.3d 1183, 47 Cal. Rptr. 3d 233 (2006), in support of the exclusion of the gross receipts from the sale of financial instruments from the taxpayer's sales factor denominator.

Again, section 304(f) explicitly provides for modification of the apportionment provisions to avoid unfair representation of the extent of the taxpayer's business activity in Illinois. 35 ILCS 5/304(f) (West 2002). The inclusion of the gross receipts from the sale of financial instruments in Mead's sales factor denominator would not have resulted in a fair representation of its business activity; the gross receipts add approximately $4.8 billion to Mead's sales factor denominator when it actually earned only about $1.9 million on those investments. Accordingly, we believe summary judgment was properly granted in favor of the Department on this issue.

Therefore, we affirm the judgment of the circuit court as set forth in its orders of December 2, 2002, and March 18 and 25, 2003.

Affirmed.

McNULTY and O'MALLEY, JJ., concur.

APPENDIX B

No. 1-03-1160

IN THE
APPELLATE COURT OF ILLINOIS
FIRST JUDICIAL DISTRICT

THE MEAD CORPORATION, an Ohio corporation, Plaintiff-Appellant, v. ILLINOIS DEPARTMENT OF REVENUE, GLEN L. BOWER, Director of the Illinois Department of Revenue, and JUDITH BAAR TOPINKA, Treasurer of the State of Illinois, Defendants-Appellees.	On Appeal from an Order of the Circuit Court of Cook County, Illinois, County Department, Law Division. No. 00 CH 07854 The Honorable ALEXANDER P. WHITE, Judge Presiding.

ORDER

(Entered Jan. 3, 2007)

THIS CAUSE COMING TO BE HEARD on the motion of the ILLINOIS DEPARTMENT OF REVENUE, GLEN L. BOWER, former Director of the Illinois Department of Revenue and JUDITH BAAR TOPINKA, Treasurer of the State of Illinois to Publish Rule 23 Order as a Precedential Decision, due notice having been given;

IT IS HEREBY ORDERED that the Motion to Publish Rule 23 Order as a Precedential Decision, is GRANTED/ ~~DENIED~~.

IT IS FURTHER ORDERED that: the Rule 23 order filed in this cause on November 3, 2006 is withdrawn, and an Opinion in the above-captioned cause will follow.

ENTER:

/s/ Justice Fitzgerald Smith
JUDGE

/s/ Jill K. McNulty
JUDGE

/s/ Denise M. O'Malley
JUDGE

DATED: [Stamped Jan. 3, 2007]

BRIAN F. BAROV
Office of the Attorney General
Civil Appeals Division

APPENDIX C

IN THE CIRCUIT COURT
OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, LAW DIVISION
TAX AND MISCELLANEOUS REMEDIES SECTION

THE MEAD CORPORATION, Plaintiff, v. ILLINOIS DEPARTMENT OF REVENUE, GLEN L. BOWER, Director of the Illinois Department of Revenue, and JUDY BAAR TOPINKA, Treasurer of the State of Illinois, Defendants.	No. 00 CH 07854 Transferred to Law Division Calendar 1 Judge Alexander P. White

FINAL JUDGMENT ORDER

THIS CAUSE coming to be heard on the Defendants' Motion for Final Judgment, the parties represented through counsel, and being fully advised in the premises,

THE COURT HEREBY FINDS THAT:

A. All issues presented in the First Amended Verified Complaint have been resolved in favor of the Defendants by virtue of the findings of fact and conclusions of law reached in the Memorandum, Decision, Judgment and Orders entered on December 2, 2002, and March 18, 2003,

B. Because this action was initiated under the Protest Monies Act, no remand to the Department of Revenue is necessary,

C. No issues remain to be decided by this court except the entry of final judgment consistent with the court's rulings in the Memorandum Decision, Judgment and Orders entered on December 2, 2002, and March 18, 2003,

NOW, THEREFORE, THE COURT HEREBY ORDERS THAT:

1. The preliminary injunctions entered on March 3, 1999, and January 3, 2001, are dissolved;

2. Judgment is entered in favor of the Defendants and against the Plaintiff in the amount of $4,238,221, which represents the payments made under protest in the amount of $4,163,322 on February 3, 1999, and $74,889 on December 15, 2000;

3. The State Treasurer shall transfer the protest payments in the amount of $4,238,221 out of the Protest Fund and into the appropriate state fund;

4. This Final Judgment Order represents a complete disposition of all remaining issues in this matter, including a complete disposition of all issues remaining after the entry of the Memorandum, Decision, Judgment and Orders on December 2, 2002, and March 18, 2003, and is therefore a final and appealable order under Supreme Court Rule 303; and

5. Enforcement of this Final Judgment Order is stayed pending appeal without bond pursuant to Supreme Court Rule 305.

ENTER: /s/ Alexander P. White

DATE: [Stamped March 25, 2003]

LISA MADIGAN, Illinois Attorney General
BRIAN E. FLIFLET, Assistant Attorney General
Revenue Litigation Bureau
100 W. Randolph St., Room 13-225
Chicago, IL 60601
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APPENDIX D

**IN THE CIRCUIT COURT OF
COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT - LAW DIVISION
TAX AND MISCELLANEOUS REMEDIES SECTION**

MEAD CORPORATION,	)	
Plaintiff,	)	
vs.	)	
ILLINOIS DEPARTMENT OF REVENUE, GLEN L. BOWER, Director of the Illinois Department of Revenue, and JUDY BAAR TOPINKA, Treasurer of the State of Illinois,	)	**No. 00 CH 7854**
Defendants.	)	

MEMORANDUM DECISION, JUDGMENT AND ORDER

The matter is before the Court on the complaint filed by Plaintiff, Mead Corporation ("Mead"), against the Illinois Department of Revenue ("Department"), Glen L. Bower, and Judy Baar Topinka ("Defendants"). Mead objects to the assessment of the Department relative to the proceeds of the liquidation of the electronic publishing division of Mead which included Mead Data Central, Inc. (collectively referred to as "Lexis/Nexis").

STATEMENT OF FACTS

Plaintiff, Mead, filed Illinois corporate income and replacement tax returns for 1993 and 1994. On its 1993 return, Mead included Lexis/Nexis in its unitary business

group. On December 31, 1993, Lexis/Nexis merged into Mead as a division. Mead sold the assets of Lexis/Nexis to Reed Elsevier on December 2, 1994 for $1.5 billion. On its 1994 Illinois income and replacement tax return, Mead reported the gain on the sale as non business income.

The Department audited Mead for 1993 and 1994. Audit Adjustments made for 1993 are not disputed. For 1994, the Department determined the gain on the sale constituted business income and apportioned it to Illinois in accordance with the Illinois Income Tax Act (the "Act"). The Department also recomputed Mead's apportionment factor including in the denominator of the sale factor not only the gain realized but also the return of capital invested, as reported by Mead. This issue was dealt with in a separate proceeding. As a result, the Department issued a Notice of Deficiency which was paid under protest, and Mead filed this action pursuant to the Protest Monies Act.

SUMMARY OF TESTIMONY OF WITNESSES BY PARTY

1. Plaintiff's Witnesses:

James P. Roemer, former head of operations of Mead Data Central, testified about the development of Lexis/Nexis during his tenure from 1970 until 1991, becoming acting president in 1982. He also testified to the nature of the relationship and the differences in culture and location between Mead and Lexis/Nexis during that time period.

James M. McGrane, currently an employee of Mead Corporation, testified about the relationship of the marketing and advertising functions at Mead and at Lexis/Nexis from the time he was hired by Lexis/Nexis in 1984 as director of market planning and development until

1994 when he was in Mead's strategy department having transferred there in 1992. He also testified to the relationship of his department within the operational structure of Lexis/Nexis.

Timothy R. McLevish testified he was an employee at Mead from 1987-92, vice president of financial resources and administration at Lexis/Nexis from 1992-93, and left Mead just prior to trial as their Chief Financial Officer. He testified to the changes in the legal structure of Lexis/Nexis and its effect on operations, and also how their finance departments interacted, both in terms of financial transactions and in terms of operations and policy making.

Walter Hellerstein, Professor of Taxation at the University of Georgia School of Law, was stipulated as an expert in the field of tax policy. Prof. Hellerstein testified as to his analysis of the question of whether the income derived from the disposition of Lexis/Nexis should be included in Mead's apportionable tax base for the State of Illinois.

Ferdinand P. Schoettle, Professor of Law at the Law School of the University of Minnesota and a private consultant, was stipulated as an expert in the field of economics. Dr. Schoettle testified as to his analysis of questions that go to the relationship between Mead and Lexis/Nexis.

Kennion K. Yano, Director of Deloitte & Touche L.L.P.'s Multistate Tax practice in Houston, Texas, was stipulated as an expert in the field of accounting. Mr. Yano testified as to his analysis of the 1994 Mead Company on a separate accounting basis in Illinois and the factor representation calculation on the gain on the sale of Lexis/Nexis.

Richard D. Pomp, Professor of Law at the University of Connecticut, Adjunct Professor of Law at New York University and Columbia University, and Visiting Professor every other year at Harvard Law School, was stipulated as an expert in the field of tax policy. Prof. Pomp testified as to his analysis which applied normative principles of state tax policy to determine if these principles would support the taxation of gain on the sale of Lexis/Nexis by the State of Illinois.

2. Summary of Defendant's Witness:

Frederick A. Murray, a revenue auditor for the Illinois Department of Revenue, testified on the conclusions reached by audit of the Mead Company's Illinois corporate income and replacement tax returns for 1993 and 1994.

EXHIBITS

1. Stipulated before trial:

Exhibit 1 – Illinois corporate Income and Replacement Tax Return for the year 1994

Exhibit 2 – Notice of Deficiency dates December 10, 1998

Exhibit 3 – February 3, 1999 payment and enclosed correspondence

Exhibit 4 – Agreed Order dated May 8, 2000

Exhibit 5 – Notice of Deficiency dated October 27, 2000

Exhibit 6 – December 15, 2000 payment and enclosed correspondence

Exhibit 7 – May 16, 1994 Mead Press Release

Exhibit 8 – Two Articles from Tuesday, May 17, 1994, *Dayton Daily News* entitled "Exiting info

highway, Mead to sell data unit, concentrate on forest products" (Summaries on right hand side of page 1A), and "3,800 workers include 2,000 employed here."

Exhibit 9 – Article from Tuesday, May 17, 1994, *Dayton Daily News* entitled "Mead plans future on paper."

Exhibit 10 – Mead's Motion for Partial Summary Judgment and Memorandum in Support of its motion

Exhibit 11 – Defendant's Response and Cross Motion for Partial Summary Judgment

Exhibit 12 – Mead's Reply Regarding its Motion for Partial Summary Judgment

Exhibit 13 – Order granting Mead's Motion for Partial Summary Judgment

Exhibit 14 – Qualifications of Professor Walter Hellerstein

Exhibit 15 – Qualifications of Professor Richard D. Pomp

Exhibit 16 – Qualifications of Dr. Ferdinand P. Schoettle

Exhibit 17 – Qualifications of Mr. Kennion K. Yano

Exhibit 19 – Illinois Corporate Income and Replacement Tax Returns for the year 1988, together with Notice of Disposition.

Exhibit 20 – 1988 IL 1120-X

Exhibit 21 – Auditor's Comments

Exhibit 22 – Illinois Corporate Income and Replacement Tax Returns for the year 1993

Exhibit 23 – 1993 Annual Report

Exhibit 24 – 1994 Annual Report

Exhibit 25 – 1993 Form 10-K

Exhibit 26 – 1994 Form 10-K

Exhibit 27 – Board of Directors minutes: 12/11/80, 7/26/84, 12/10/93, 2/24/94, 4/27/94, 4/28/94, 5/14/94, 8/4/94, 10/4/94, 10/29, 94, 12/9/94 (as redacted by Mead)

Exhibit 28 – Unanimous Written Consent of the Debt Committee, 12/3/94

Exhibit 29 – Mead Corp. Gross Receipts 1994

Exhibit 30 – Mead Corporation, report by Goldman, Sachs & Co., 10/21/94

Exhibit 31 – Mead Corporation: Alternatives for Reinvestment of MDC Proceeds, report by Goldman, Sachs & Co., 9/8/94

Exhibit 32 – Notices of Redemption to Bankers Trust Co. and Citibank, N.A., 12/6/94

Exhibit 33 – Press Release, Mead Board Authorizes Program for Stock Buyback; Debt Reduction, 10/31/94

Exhibit 34 – Press Release, Mead Corp. Board Calls Debentures for Redemption and Authorizes Repurchase of Notes, 12/7/94

Exhibit 35 – Memorandum from L. J. Frances to T. E. Palmer, MDC's Proposed Merger Writeup, 11/17/93

Exhibit 36 – Memorandum from Eve Kempfer to David A. Heuhardt, mead Data Central/Mead Digital Systems merger, with attachments, 1/13/80

Exhibit 37 – Recommendation to Board of Directors re: Liquidation/Merger of Mead Data Central Inc. and Mead Digital Systems Inc. 12/11/80.

2. Admitted during trial:

Plaintiff's Exhibit C: The Mead Corporation: 1994 Illinois Operations prepared by Mr. Yano of Deloitte & Touche

Defendant's Exhibit A: Workpapers of Mr. Murray, auditor for the Department of Revenue

RULINGS ON CONTESTED ADMISSION OF EXHIBITS TAKEN UNDER ADVISEMENT

IT IS HEREBY ORDERED THAT:

1. Defendant's objection to Plaintiff's Exhibit A: Expert Report of Walter Hellerstein as hearsay is denied and the report is admitted for the opinions expressed. The bases for the opinions are not accepted as substantive evidence.

2. Defendant's objection to Plaintiff's Exhibit B: Expert Report of Ferdinand P. Schoettle as hearsay is denied and the report is admitted for the opinions expressed. The bases for the opinions are not accepted as substantive evidence.

3. Defendant's objection to Plaintiffs Exhibit D: Expert Report of Richard D. Pomp as hearsay is denied and the report is admitted for the opinions expressed. The bases for the opinions are not accepted as substantive evidence.

4. Defendant's objections to the admissibility of testimony, which required reading from Plaintiff's Exhibit A, is denied.

5. Defendant's objections to the admissibility of testimony, which required reading from Plaintiff's Exhibit B, is denied.

6. Defendant's objection to strike reference to the outside experts during the testimony of Plaintiff's witness Dr. Schoettle as hearsay is sustained.

7. Defendant's objection to admit the statement of Mr. Yana, Plaintiff witness, that in his opinion the separate accounting calculation shows distortion as not relevant, is sustained.

8. Plaintiff's objection to question of Mr. Murray, regarding calculations relative to the correct denominator for the apportionment formula was determined by the Court in the motion for partial summary judgment.

FINDINGS OF CONTESTED FACTS

1. Mead and Lexis/Nexis were not functionally integrated.

While Mead was more involved with Lexis/Nexis than with a passive investment, day-to-day Mead and Lexis/Nexis operated as two discrete entities. Mr. McGrane, who worked at Lexis/Nexis and then transferred to Mead, testified that there was no joint advertising, Lexis/Nexis had its own internal security department, its own human resources department, and its own facilities. Mr. McLevish testified that Lexis/Nexis had its own real estate department. The overlap of Board of Director involvement for extraordinary purchases requiring capital investment and the interest rate advantage gained by Mead through the nightly sweep of bank accounts is not sufficient evidence that the two were functionally integrated.

2. Mead and Lexis/Nexis did not share a centralized management.

Mead's involvement with Lexis/Nexis was primarily through approval of extraordinary purchases and considering the operations of Lexis/Nexis in its own strategic planning. That is not centralized management.

3. There were no economies of scale realized by Mead and Lexis/Nexis.

The testimony of Mr. McGrane explains that they had not shared facilities since 1984; they had separate purchasing departments and no joint purchasing activity. Mr. Roemer testified that Mead customers received no discounts if they were also Lexis/Nexis customers and vice versa. In addition, he testified that neither company enjoyed nor was offered a discount nor required to purchase the products or services of the other. The testimony was that Lexis/Nexis often bought paper from other vendors. According to Mr. McLevish, the only economy of scale presented was the increased interest rate enjoyed by Mead as a result of included Lexis/Nexis account balances in determining what interest rate applied.

4. Mead was involved in the electronic publishing business.

As the evidence stipulated to by the parties shows, Mead considered itself in the electronic publishing business in 1993 as attested to both in Exhibit 23, Mead's 1993 Annual Statement and in its 1993 Form 10-k. This was after the merger of the subsidiary into Mead. In 1994, after the sale of Lexis/Nexis both the Annual Statement and the Form 10-k reflect that Mead is no longer in the

electronic publishing business. Thus at all relevant times prior to the sale of Lexis/Nexis, Mead's business operations included Lexis/Nexis and, therefore, Mead was in the electronic publishing business.

5. With its sale of Lexis/Nexis, Mead liquidated any interest in electronic publishing.

The extent of Mead's operations in electronic publishing was represented by their interest in Lexis/Nexis. With the sale of Lexis/Nexis, all electronic publishing activities ceased. Evidence of that is provided by the 1994 Annual Statement and the 1994 Form 10-k, which make no mention of electronic publishing in its statement of business or its review of operations.

6. Mead reinvested the proceeds from the liquidation of Lexis/Nexis in Mead.

Based on stipulations made pretrial, the proceeds from the sale of Lexis/Nexis were used to repurchase Mead stock, retire debt and pay taxes. That has not been contested.

7. The sale of Lexis/Nexis included assets which were situated in Illinois and used in the production of income reported to Illinois.

That activity provides a nexus between Illinois and Lexis/Nexis that reaches the gain on the sale. Work papers provided by Mr. Murray and the report provided by Mr. Yano both show that there were assets, personnel and sales of Lexis/Nexis in Illinois for the 1994 year.

8. Mead was not in the business of disposing operating divisions, and the sale of Lexis/Nexis was not in the ordinary course of business.

Mead's operating divisions did not include a focus on disposing of large sections of its operations. Mead sale of Lexis/Nexis was a strategic decision to protect itself from take over through restructuring debt and repurchasing capital.

9. Mead's returns which included Lexis/Nexis as part of its unitary group in 1994 does not create a presumption that a unitary relationship existed.

Testimony indicated that the inclusion of Lexis/Nexis as part of Mead was originally a determination of the Department. Over the time that Lexis/Nexis was included as part of Mead's unitary group, Mead enjoyed substantial tax savings from an operating loss that would otherwise have expired. By that determination, Mead was compelled to file as unitary or appeal to the Department. Since it would be to their disadvantage to do so, the presumption acknowledged by their filing was that they were not actively seeking to pay more in income taxes.

10. Mead's investment in Lexis/Nexis did serve an operational purpose, in that Lexis/Nexis represented a significant business segment of Mead.

While it is clear from the testimony of Mr. McLevish and Mr. Roemer that there was no functional integration, it is not clear that there was no operational purpose. Lexis/Nexis was considered in the strategic planning of Mead, particularly in the allocation of resources. The

operational purpose allowed Mead to limit the growth of Lexis/Nexis if only to limit its ability to expand or to contract through its control of its capital investment.

11. Mead is the appropriate entity to tax on the gain of the sale of Lexis/Nexis.

The sale of Lexis/Nexis represented a complete liquidation of an operating segment of Mead. Mead reported that sale as part of its income as the sale of individual assets, with the balance as goodwill. As Mr. Murray testified, Lexis/Nexis was not a taxable entity and Mead was the entity required to report the gain.

12. The amount of gain recognized as goodwill is gain attributable to the assets of Lexis/Nexis.

The goodwill is identified as a lump sum gain. The auditor applied goodwill to the assets that were sold in the transaction and recognized the portion of that gain that applied to the assets in Illinois relative to total assets. If this is business income, that is a reasonable basis on which to allocate the gain.

CONCLUSIONS OF LAW

1. Mead and Lexis/Nexis are not unitary.

As determined in the fact finding, Mead and Lexis/Nexis were not functionally integrated, there was no centralization of management and no significant economies of scale between the two businesses. Filing as a unitary group at the direction of the Department of revenue is not sufficient to overcome the conclusion that the two entities are not unitary.

2. **The sale of Lexis/Nexis represented a liquidation in the business activity of electronic publishing, and the property disposed of in that liquidation was "essential to the taxpayer's regular trade or operations" and therefore business income.** *Blessing/White, Inc. v. Zehnder,* 329 Ill. App. 3d 714, 726.

The gain on the sale of Lexis/Nexis was part of the strategic business plan of Mead and the disposition of those assets was made for the benefit that the gain would provide to Mead. *Id.* at 728. Thus, the gain does meet the functional test and is properly identified as business income.

The Court determines that the case be sent to the Department of Revenue to recalculate the tax consistent with this opinion.

ENTER /s/ Alexander P. White
JUDGE Alexander P. White

[Stamped Mar. 18, 2003 Circuit Court – 241]

APPENDIX E

SUPREME COURT OF ILLINOIS
CLERK OF THE COURT
SUPREME COURT BUILDING
SPRINGFIELD, ILLINOIS 62701
(217) 782-2035

January 24, 2007

Mr. Paul H. Frankel
Morrison & Foerster LLP
1290 Avenue of the Americas
New York, NY 10104

No. 103854 – The Mead Corporation, etc., petitioner, v. Illinois Department of Revenue et al., etc., respondents. Leave to appeal, Appellate Court, First District.

The Supreme Court today DENIED the petition for leave to appeal in the above entitled cause.

The mandate of this Court will issue to the Appellate Court on March 1, 2007.

APPENDIX F

No. 1-03-1160

IN THE
APPELLATE COURT OF ILLINOIS
FIRST JUDICIAL DISTRICT

THE MEAD CORPORATION, an Ohio corporation, Plaintiff-Appellant, v. ILLINOIS DEPARTMENT OF REVENUE, GLEN L. BOWER, Director of the Illinois Department of Revenue, and JUDITH BAAR TOPINKA, Treasurer of the State of Illinois, Defendants-Appellees.	On Appeal from an Order of the Circuit Court of Cook County, Illinois, County Department, Law Division. No. 00 CH 07854 **[EXHIBITS INTENTIONALLY OMITTED]** The Honorable ALEXANDER P. WHITE, Judge Presiding.

MOTION TO PUBLISH RULE 23 ORDER AS A PRECEDENTIAL DECISION

NOW COME the Defendants-Appellees, ILLINOIS DEPARTMENT OF REVENUE, GLEN L. BOWER, Director of the Illinois Department of Revenue, and JUDITH BAAR TOPINKA, Treasurer of the State of Illinois (collectively "Department"), by and through their attorney, LISA MADIGAN, Attorney General of the State of Illinois, and pursuant to Supreme Court Rule 23(f) hereby move this Honorable Court to grant this motion to change the designation of the decision in this case from an unpublished order to a published opinion for the following reasons:

1. On November 3, 2006, this Court issued its Rule 23 Order upholding the circuit court's judgment that the gain Mead Corp. realized from its sale of Lexis/Nexis was Illinois apportionable business income and upholding the validity of section 100.3380(b)(6) of the Department's regulations, which prohibited Mead from including the return of principal from its investment in short-term financial instruments in its sales factor denominator as gross receipts.

2. Supreme Court Rule 23(a)(1) provides that a decision may be published where it "establishes a new rule of law or modifies, explains or criticizes an existing rule of law." This Court's decision qualifies as a publishable decision under Supreme Court Rule 23(a)(1). First, in upholding the Department's regulation, 86 Ill. Admin. Code § 100.3380(b)(6), it has established a new rule of law. Second, its finding that the gain from the Lexis/Nexis's sale was constitutionally apportionable in Illinois, and its finding that the gain from Lexis/Nexis's sale was not subject to the business liquidation exception to the functional test for business income explains existing rules of law, in a manner not previously found in any published decisions in Illinois.

Validity of 86 Ill. Admin. Code § 100.3380(b)(6)

3. This Court's holding that 86 Ill. Admin. Code § 100.3380(b)(6) is a valid exercise of the Department's authority under section 304(f) of the Illinois Income Tax Act, 35 ILCS 5/304(f) (2004), to modify apportionment methods to avoid the unfair representation of Illinois business activity, established a new rule of law on a recurring question for the Department. (*See* Affidavit of

Mark Hellner, Chief Counsel, at ¶ 3, attached hereto and made a part hereof as Exhibit A). The identical issue is before the Cook County Circuit Court in *Home Depot, U.S.A., Inc. v. Dep't of Revenue,* No. 05 L 50316, and briefing and argument on summary judgment has been stayed in that matter pending this Court's resolution of this case. (A true and correct copy of the order of March 22, 2006 in *Home Depot, U.S.A., Inc. v. Ill. Dep't of Revenue,* is attached hereto and made a part hereof as Exhibit B). There are also seven Protest Monies Act actions pending in the Sangamon County Circuit Court which will be impacted by this Court's decision on this issue: *Limited Stores v. Dep't of Revenue,* No. 99-TX-0001/02; *Limited Stores v. Dep't of Revenue,* 2000-TX-0001/2; *Limited Stores v. Dep't of Revenue,* No. 01-TX-0001/22; *Limited Stores v. Dep't of Revenue,* No. 03-TX-0001/13; *AT & T Corp. v. Dep't of Revenue,* 04-TX-0001/6; *Goldman Sachs v. Dep't of Revenue,* No. 06-TX-0001/5 and *Illinois Bell Telephone v. Dep't of Revenue,* No. 06-TX-0001/12. In addition, the validity of a related regulation, section 100.3380(c)(2) – which excludes occasional sales from the sales factor denominator – is in issue in *Lee Enterprises, Inc. v. Hamer,* No. 04 L 50884 (Cir. Ct. Cook Co.), and the principle established by this Court that the Department can provide an alternative apportionment method by regulation will be an important issue in this case. In these cases, publication of this decision will the assist the courts and promote judicial economy by avoiding relitigation of this issue.

Constitutional Apportionment

4. In finding that the gain from Lexis/Nexis's sale was constitutionally apportionable because Lexis/Nexis served an operational function for Mead, this Court

distinguished the present case from *Hercules, Inc. v. Dep't of Revenue,* 324 Ill. App. 3d 329 (1st Dist. 2001), the only other Illinois published decision addressing whether the gain from the sale of a business unit was constitutionally apportionable. In distinguishing the present case from *Hercules,* this Court has provided important guidelines for applying the operational function test that will assist the Department in administering the Illinois Income Tax Act ("IITA") and circuit courts in resolving disputes over whether a gain realized from the sale of a business asset is constitutionally apportionable.

5. The decision provides such crucial guidance on a recurring issue because it sets forth specific factors – such as on-going capital support, approval of major capital expenditures, manipulation of business organizations, and retaining benefits and control of excess cash – on which the Department, courts and taxpayers can rely in determining when a business unit qualifies as an operational asset and thus when the gain realized from its sale is constitutionally apportionable. In addition, the decision is significant because it approved of specific evidence on which the Department and courts can rely in making this determination – such as annual reports and federal 10-K statements – and disapproved of other evidence – the testimony of experts who offer opinions on matters of law – in deciding whether a business asset serves an operational function. *See* Hellner Aff., Ex. A. at ¶ 6.

Business Liquidation Exception

6. This Court also held that the gain was business income and did not qualify as nonbusiness income under the business liquidation exception to the functional test for

business income under *Blessing/White, Inc. v. Zehnder,* 329 Ill. App. 3d 714 (1st Dist. 2002) *and American States Ins. Co. v. Hamer,* 352 Ill. App. 3d 521 (1st Dist. 2004). In distinguishing this case from *Blessing/White* and *American States* this Court has established limits on the business liquidation exception that will provide significant guidance in administering the IITA. In particular, this Court's finding that Mead reinvested the gain in its ongoing business because it used the gain to buy back stock, pay down debt, reduce its long-term debt to capital ratio and increase working capital provides practical guidance for determining when the business liquidation exception applies and is the only published decision providing this analysis and distinguishing *Blessing/White* and *American States Ins. Co. See* Hellner Aff., Ex. A at ¶ 8. Thus, it will aid taxpayers and Courts, as well as the Department.

7. Indeed, although the business income definition was amended effective July 30, 2004 by Public Act 93-840, the scope and extent of the business liquidation exception to the business income definition remains a recurring issue affecting numerous tax disputes currently before the Department and the circuit court involving millions of dollars in disputed tax liability. *See* Hellner Aff., Ex. A at ¶ 7. The scope of the business liquidation doctrine is in issue in the Fourth District Appellate Court in *National Holdings, Inc. v. Zehnder,* No. 4-06-0148 (awaiting oral argument), in the First District Appellate Court in *Shakkour v. Bower,* No. 1-04-1646, *reh. den.* Oct. 13, 2006, *motion to pub. granted* Nov. 3, 2006, *pet. for leave to appeal due* Dec. 8, 2006, in the Circuit Court of Cook County in *Gannett Satellite Info. Network, Inc. v. Ill. Dep't of Revenue,* No. 03 L 51433, and *Lee Enterprises, Inc. v. Hamer,*

No. 04 L 50884, and in the Circuit Court of Sangamon County in *Limited Stores v. Dep't of Revenue,* No. 03-TX-0001/13; *Limited Stores v. Dep't of Revenue,* No. 01-TX-0001/22; *Brown and Williamson v. Dep't of Revenue,* No. 03-TX-0001/14; *CR Bard, Inc. v. Dep't Revenue,* No. 04-TX-0001/02; *EPCO, Inc. v. Dep't of Revenue,* No. 03-TX-0001/12; *Nationwide Mutual v. Dep't of Revenue,* No. 01-TX-0001/23; and *Nicor, Inc. v. Dep't of Revenue,* No. 98-TX-0001/11. A published decision in the present case will benefit the courts and litigants in resolving these pending actions.

For the foregoing reasons, the Defendants-Appellees respectfully request that this Honorable Court publish the Rule 23 order, entered on November 3, 2006, as a precedential decision.

Respectfully submitted,

LISA MADIGAN
Attorney General
State of Illinois

BY: /s/ Brian F. Barov

BRIAN F. BAROV
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100 West Randolph Street
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APPENDIX G

EXPERT REPORT OF WALTER HELLERSTEIN

Prepared for Morrison & Foerster
Counsel for The Mead Corporation

in connection with

The Mead Corporation v.
Illinois Department of Revenue, et al.,

No. 00 CH 07854

In the Circuit Court of Cook County, Illinois
County Department, Law Division
Tax and Miscellaneous Remedies Section

Dated September 20, 2001

[EXHIBIT A RESUME INTENTIONALLY OMITTED]

[1] 1. I am Walter Hellerstein, the Francis Shackelford Professor of Taxation at the University of Georgia School of Law, where I have taught since 1978. I have devoted most of my professional life to the study of state and local taxation and have written extensively about state and local taxation. My experience and scholarly work in the field of state and local taxation are reflected in my current resume, which I have attached hereto as Exhibit A. I have prepared this report for use by Plaintiff in connection with the above captioned litigation.

2. I have been accepted as an expert witness on matters involving state and local taxation in *Appeal of Panhandle Eastern Pipe Line Co., et al.*, Nos. 98-6865-DT, 98-6866-DT, Kansas Board of Tax Appeals, Sept. 16, 1999; *Springs Industries, Inc. v. South Carolina Department of Revenue*, No. C.A. No. 99-ALJ-17-0153-CC, South Carolina Administrative Law Judge Division, May 26, 1999; *Pennzoil Company and Subsidiaries v. Department of Revenue*,

No. 4301, Oregon Tax Court, March 10. 1999; *In the Matter of the Protest of KMART Properties, Inc.*, ID No. 02-297446-00 6, Assessment Nos. 213646 and 213647, Before the Taxation and Revenue Department of the State of New Mexico, Nov. 20, 1998; *The Williams Companies Inc & Subsidiaries v. Department of Revenue of the State of Montana*, Case No. CT-1996-1, Montana State Tax Appeal Board, July 27-28, 1998; *General Motors Corporation, et al. v. Director of Revenue, State of Missouri*, Cause No. 96-001882RI, Missouri Administrative Hearing Commission, August 18, 1997; *Fleming Foods of Texas, Inc. v. Sharp*, No. 96-12390, Travis County, Texas District Court, 53rd Judicial District, March 10, 1997; *General Motors Corporation d/b/a General Motors Emissions Laboratory v. City and County of Denver*, No. 950401, Treasury Division, Department of Revenue, City and County of Denver, July 23, 1996; *In re Chrysler [2] Corporation*, No 40-910308-2, Philadelphia Tax Review Board, Sept. 14, 1995; *Mississippi Power & Light Co., et al. v. Mississippi State Tax Commission*, Civil Action Nos. 154,261-154,263, Chancery Court of the First Judicial District of Hinds County, Mississippi, December 13, 1994; *Peabody Coal Co. v. The Navajo Nation*, No. CIV 88-0931-PCT-BMV, United States District Court for the District of Arizona, March 18, 1994; *Chevron U.S.A., Inc. v. Mississippi State Tax Commission*, Cause No. 148,792, Chancery Court of the First Judicial District of Hinds County, Mississippi, January 25, 1993; *H. A. True. Jr., et al. v. Tax Commissioner of the State of North Dakota*, Civil No. 38367, North Dakota District Court, South Central Judicial District, Burleigh County, October 12, 1989; *American Telephone & Telegraph Co. v. Commissioner of Revenue*, Docket Nos. 146547-146550, Massachusetts Appellate Tax Board, June 7, 1989; *J.C. Penney Co. v. City of Tacoma*, Docket No. 271861, Superior

Court, Pierce County, State of Washington, March 10, 1989; *American Telephone and Telegraph Co. v. State Tax Appeal Board*, Docket No. CDV 86-823, District Court of the First Judicial District of the State of Montana, Lewis and Clark County, June 6, 1988; *Burlington Northern Railroad Co. v. Wyoming State Tax Department*, No. C-87-0252, United States District Court for the District of Wyoming, May 1, 1988; *Union Pacific Railroad Co. v. Public Utility Commission of the State of Oregon*, Civil No. 86-778-PA, United States District Court for the District of Oregon, July 13, 1987; *Kansas City Southern Railway v. McNamara*, 624 F. Supp. 395 (M.D. La. 1985); *In re Factual Issues in Cause No. 83-551 of the Supreme Court of Montana (Burlington Northern, Inc. v. Schwinden)*, District Court of the First Judicial District of the State of Montana, Lewis and Clark County, May 25, 1984; and *Alabama Great Southern Railway v. Eagerton*, 541 F. Supp. 1084 (M.D. Ala. 1982).

[3] 4. I have testified at the invitation of Committees of the United States Congress on matters involving state and local taxation in *Hearings on H.R. 1054, the "Internet Tax Freedom Act," Before the Subcomm. on Commercial and Administrative Law of the House Committee on the Judiciary*, 105th Cong., 1st Sess. (July 17, 1997); *Hearings on the Effect of Interstate Branching on National, State, and Local Economies Before the Subcommittee on Economic Stabilization of the House Committee on Banking, Finance, and Urban Affairs*, 102d Cong., 1st Sess. (May 15, 1991), *Hearings on the Interstate Sales Tax Collection Act of 1987 and the Equity in Interstate Competition Act Before the Subcommittee on Monopolies and Commercial Law of the House Committee on the Judiciary*, 100th Cong., 2d Sess. (Sept. 21, 1988), *Hearings on the Severance*

Tax Equity Act of 1982 Before the Subcommittee on Energy and Agricultural Taxation of the Senate Committee on Finance, 98th Cong., 2d Sess. (July 24, 1984), and *Hearings on the Commerce Clause and State Severance Taxes Before the Subcommittee on Intergovernmental Relations of the Senate Committee on Government Affairs*, 97th Cong., 1st Sess. (July 15, 1981). I have testified before state legislative bodies in the following states on the following matters relating to state and local taxation: Florida, sales tax on services; Georgia, severance tax on kaolin; Louisiana, coastal wetlands environmental levy; Michigan, Single Business Tax apportionment; and Texas, criteria for a viable state tax structure. I have testified at the invitation of the Advisory Commission on Electronic Commerce created by Congress on "The Law of Sales Taxation in a Cyberspace Economy" (June 22, 1999).

5. I have consulted with states and with private industry on a wide variety of issues involving state and local taxation and related matters. My consulting activities with states [4] include: Alaska, providing advice regarding the constitutionality of proposals to revise Alaska's oil and gas income tax and drafting substantial portions of the state's briefs in *South-Central Timber Development, Inc. v. Wunnicke*, 467 U.S. 82 (1984); Delaware, providing advice regarding state income tax issues; Florida, drafting legislation for a sales tax on services and defending the constitutionality of the legislation in the Florida courts; Georgia, providing advice to the Georgia Department of Revenue on income, sales and use, and property tax issues; Louisiana, drafting legislation for a coastal wetlands environmental levy and defending the constitutionality of the legislation before legislative bodies; Montana, drafting substantial portions of the state's briefs

in the state district court, the state supreme court, and the United States Supreme Court defending the constitutionality of Montana's coal severance tax in *Commonwealth Edison Co. v. Montana*, 453 U.S. 609 (1981); North Dakota, providing expert assistance in a state income tax controversy; Texas, serving as a consultant to the Texas Select Committee on Tax Equity; and Virginia, defending the State Department of Revenue in an income tax refund suit. My consulting activities with private industry include advice and assistance on income, sales and use, property, and miscellaneous excise taxes, particularly with regard to federal constitutional issues raised by such levies, and I have participated on behalf of private industry in litigation before the United States Supreme Court in *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978), *American Trucking Associations, Inc. v. Scheiner*, 483 U.S. 266 (1987), *McKesson Corp. v. Division of Alcoholic Beverages and Tobacco*, 496 U.S. 18 (1990), *Trinova Corp. v. Michigan Department of Treasury*, 498 U.S. 358 (1991), *Chemical Waste Management, Inc. v. Hunt*, 504 U.S. 334 (1992), *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), a case I argued; *Colgate Palmolive Co. v. Franchise Tax* [5] *Board*, 512 U.S. 298 (1994), *General Motors Corp. v. Tracy*, 519 U.S. 278 (1997), and *Hunt-Wesson, Inc. v. Franchise Tax Board.*, 528 U.S. 458 (2000), a case I argued.

6. I have frequently been a faculty member at continuing education programs devoted to state and local taxation, as indicated on pages 2-4 of my resume (see Exhibit A).

7. Based on my review of various documents produced by the parties in this case, including Plaintiff's

Response to Defendants' First Set of Written Interrogatories dated August 20, 2001, Plaintiff's First Amended Verified Complaint and Exhibits A, B, C, and D thereto filed January 4, 2001, the Reply of Plaintiff filed April 26, 1999, the Answer of Defendants filed April 2, 1999, and on conversations with employees of the Mead Corporation and with counsel, and relying on materials regularly and reasonably relied upon by persons in my field and on my own knowledge of the law and policy relating to state taxation, my opinions and conclusions at this time are as follows:

Mead and MDC Were Two Discrete Business Enterprises Engaged in Unrelated Business Activity, and Illinois Therefore May Not Include Mead's Income From Its Sale of MDC in Mead's Apportionable Tax Base

During the tax year at issue (1994), and, indeed, for many years prior to 1994, The Mead Corporation ("Mead") and Mead Data Central ("MDC"), were two discrete business enterprises that were engaged in unrelated business activities. Consequently, Illinois may not require Mead to include in its apportionable tax base the income it earned from its 1994 sale of MDC. My opinion and conclusion are based on the following facts and analysis.

Mead was engaged in the business of producing and selling forest products, including paper, packaging and paperboard, and school and office supplies. MDC was in [6] the business of providing online information services for legal, news, and financial information. Indeed, MDC was a pioneer in the field of computer-assisted research, having developed the LEXIS/NEXIS service in the 1970s.

From the time of its acquisition by Mead in 1968 through its sale in 1994, MDC operated as an enterprise that was discrete from, and unrelated to, Mead's other lines of business. In fact, apart from ownership, there were no substantial unitary or operational connections between Mead's core forest products and related businesses and MDC's on-line information service business. Specifically:

1. *There was no meaningful functional integration between Mead and MDC.* Because they were involved in discrete and unrelated enterprises, there were almost no flows of goods, personnel, or intangible values between the two enterprises. Mead's purchases of information services from MDC amounted to less than one-tenth of one percent (0.1%) of its purchases. Similarly, MDC's purchases of forest products from Mead amounted to less than one-tenth of one percent (0.1%) of its purchases. By any reasonable standard, such de minimis intercompany product flows fall beneath the level that would constitute functional integration.

Moreover, the respective products produced by Mead and MDC fell outside each of the other enterprise's core (and discrete) lines of business. When Mead purchased information services from MDC, it was acquiring services that were peripheral to its core business – production and sale and forest products. Similarly, when MDC purchased forest products from Mead, it was acquiring products that were peripheral to its core business – providing an on-line data base. Furthermore, such purchases were all made on [7] an arm's-length basis on the same terms that they would have been made between unrelated parties.

There was likewise little interchange of personnel between Mead and MDC. Because of the disparate nature

of their operations, there was little opportunity for employees in Mead's forest products and related operations to serve any useful function in MDC's information services businesses. By the same token, there was little opportunity for employees in MDC's information services business to serve any useful function in Mead's forest products and related operations.

There was no flow of intangibles between Mead and MDC that can be characterized as functional integration. Mead did not share the patents, trade secrets, or other intellectual property developed in its forest products business with MDC and MDC did not share the patents, copyrights, trade secrets, or other intellectual property developed in its on-line information business with Mead.

2. *There was no meaningful centralized management of Mead's and MDC's operations.* Mead and MDC were managed as separate and discrete enterprises. Except for the type of occasional oversight that any parent or owner gives to an investment in a subsidiary or a division, there was no centralized management of Mead and MDC. MDC's management made all of its day-to-day operating decisions independently without Mead's approval.

3. *There were no economies of scale that Mead and MDC enjoyed as a result of their relationship.* Because Mead and MDC were engaged in such fundamentally different and unrelated enterprises, there were no economies of scale that accrued to Mead or MDC as a result of their common ownership. Both Mead and MDC had their [8] own purchasing departments, and there was no joint purchasing of the supplies or inputs that were essential to either Mead's or MDC's core businesses. Mead's purchases of timberlands or other goods and services related to its

forest products business were not increased by any purchasing requirements of MDC. Similarly, MDC's purchases of information data bases and other goods and services related to its on-line information service business were not increased by any purchasing requirements of Mead. Indeed, MDC relied substantially on its own internal resources (including software and data base designers), which were wholly unrelated to Mead's operations, in developing its on-line information business. Moreover, there was little sharing even beyond the two enterprises' core businesses. For example, there were no centralized computer services and MDC did not purchase its paper from Mead.

4. *There was no substantial flow of value between Mead and MDC.* Because the relationship between Mead and MDC reveals no substantial functional integration, no centralized management, and no economies of scale, there was no substantial flow of value between the two enterprises. Moreover, as noted above, there is no evidence of sharing of intangible values between the two enterprises that might be characterized as a substantial flow of value. Mead did not share the intellectual property developed in its forest products business with MDC and MDC did not share the intellectual property developed in its on-line information business with Mead.

There was no overall corporate culture that Mead imparted to MDC. To the contrary, the corporate cultures of the two enterprises were quite different – almost adversarial or hostile. Each enterprise had its own, separate physical facilities. Each had its own security procedures, so that employees of Mead did not have ready access to the [9] facilities of MDC. And each had its own dress code,

reflecting the more formal atmosphere at Mead and the more casual atmosphere at MDC.

5. *Mead did not serve an operational function in MDC's business and MDC did not serve an operational function in Mead's business.* In light of the facts set forth above, it is apparent that neither Mead nor MDC served an operational function in each other's discrete business. From Mead's standpoint, the only operational connection between it and MDC were the information services that MDC provided to Mead. Not only were these de minimis – less than one tenth of one percent (0.1%) of Mead's purchases – but they were peripheral to Mead's core operations, which involved forest products, not information. Moreover, Mead purchased the services at arm's length from MDC. From MDC's standpoint, the only operational connection between it and Mead were the general oversight that any owner of a discrete business enterprise provides to a subsidiary or division and some incidental management services that had no relationship to MDC's core business, the providing of information services.

In summary, because the relationship between Mead and MDC involved no meaningful functional integration, centralized management, or economies of scale; because there was no significant flow of value between Mead and MDC; and because neither Mead nor MDC served an operational function in each other's business, Illinois lacks the power to include the gain that Mead (a nondomiciliary corporation) earned from its disposition of MDC.

This conclusion follows from the fundamental requirement governing the exercise of state taxing power that there must be some definite link or minimum connection between a state and both the person and the activity

that the state seeks to tax. It is well [10] settled that in the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the state seeks to tax. The underlying rationale for this virtually axiomatic proposition is that the exercise of a state's tax power over a taxpayer's activities is justified by the protection, opportunities and benefits the state confers upon such activities. If the state lack the definite link or minimum connection with the activities in question, it has not given anything for which it can ask return.

In this case, Illinois lacks the authority to include the gain that Mead derived from its sale of MDC in Mead's apportionable tax base because it lacks the definite link or minimum connection with the activity that produced that gain. The activity that produced Mead's gain from the sale of MDC was Mead's activity as an investor in a discrete and unrelated enterprise. This activity occurred in Mead's headquarters and commercial domicile of Ohio, not in Illinois. Accordingly, Illinois lacked the power to include Mead's gain from the sale of MDC in Mead's apportionable tax base.

APPENDIX H

[1] EXPERT OPINION OF PROFESSOR RICHARD D. POMP[1]

The Mead Corporation v. Illinois Dept. of Revenue

I. Introduction

You have contacted me as the former Director of the New York Tax Study Commission and as someone who for nearly 25 years has studied, lectured, taught, published, and consulted with, and testified on behalf of state governments, on the subject of state taxation. You have asked me to comment on how the normative principles of state taxation should be applied to The Mead Corporation (Mead). Specifically, you asked my opinion regarding the proper treatment from a policy perspective of the receipt by Mead in 1994 of gain on the liquidation of its ownership of Mead Data Central, which represented the complete disposition and liquidation of Mead's separate and distinct electronic publishing business.

II. Background and Overview

Mead is headquartered and commercially domiciled in Ohio. Mead's core business is in the paper and timber business: packaging and paperboard, forest products, timberlands, and school and office products. In 1968, Mead acquired Data Corporation, an incipient electronic publisher that would go on to provide online information services involving legal, news and financial information.

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[1] Alva P. Loiselle Professor of Law, University of Connecticut Law School; Adjunct Professor of Law, NYU Law School (LL.M Program in Taxation); Adjunct Professor of Law, Columbia Law School; former Director, N.Y. Tax Study Commission.

Data pioneered the field of computer assisted research in the early 1970's with its LEXIS and, subsequently, its NEXIS service, and will hereinafter be referred to as Lexis/Nexis. In 1994, Lexis/Nexis[2] was sold to Reed Elsevier plc. The sale represented the complete disposition and liquidation by Mead of its electronic publishing business. The proceeds of the liquidation were primarily used by Mead to buy back its stock and to reduce its debt.

Mead has nexus with Illinois. In filing its Illinois income tax return, Mead classified the gain on the liquidation of Lexis/Nexis as nonbusiness income.[3] The Illinois Department of [2] Revenue (Department) has challenged this characterization, arguing that the income should be treated as business income[4] and apportioned to Illinois by Mead.

III. Normative policy considerations governing the income taxation of multistate corporations

Normative principles of state tax policy dictate that a state can tax only those corporations with which it has a minimum connection, relationship, or nexus. Even if this minimum relationship exists, however, a state

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[2] During some years, Lexis/Nexis was owned in the form of a subsidiary, known as Mead Data Central, Inc.; in other years, Lexis/Nexis was a division of Mead. In 1994, the year of the sale, Lexis/Nexis was a division. The manner in which Mead owned Lexis/Nexis is irrelevant to the analysis in the text.

[3] 35 ILCS 5/1501(a)(13).

[4] For the definition of business income, see 35 ILCS 5/1501(a)(1). Nonbusiness income is defined as "all income other than business income or compensation." 35 ILCS 5/1501(a)(13).

cannot tax the entire income of a non-domiciliary corporation. A state cannot tax income earned outside its borders but is limited to taxing only income attributable to activities taking place within its borders. A state needs some method for determining how much of the income of a multistate corporation should be considered as earned within its borders.

Principles of state tax policy also mandate that a rational relationship must exist between the income that a state attributes to itself and the intrastate activities of the taxpayer. In other words, a state may tax only income that is fairly apportioned to a corporation's activities in the taxing state.

There are three general approaches for applying these principles in determining whether, and how, a state may tax the income of a corporation: separate accounting, formulary apportionment, and specific allocation.

Under separate accounting, the Illinois income of a multistate corporation like Mead would be determined by isolating through accounting techniques the taxable portions of the corporation that are carried on within the State. Because Mead is a multistate corporation, separate accounting would isolate those income-generating activities that take place in Illinois and determine how much income is attributable to such activities.

The second of the three methods is known as formulary apportionment, which is the method that the Department is seeking to use in this case. Under this approach, a formula is used to apportion Mead's unitary business income to those states in which it has payroll, property, or sales. More specifically, the formula is used to generate an

apportionment percentage that is based on the relative amount of a taxpayer's in-state activities.

[3] One common formula that is used elsewhere in the country, but not in Illinois, uses the average of a taxpayer's payroll, property, and sales, with each factor being evenly weighted. During the year at issue, in 1994, Illinois used a variation on this formula in which it double weighted the sales factor. Specifically, Illinois used the following formula for apportioning the unitary business income of a multistate corporation, which the Department asserts should also be applied to the gain on the liquidation of Lexis/Nexis:

$$TI_{IL} = TI_{WW} \times 1/4\ (2 \times Sales_{IL}/Sales_{WW} + Payroll_{IL}/Payroll_{WW} + Property_{IL}/Property_{WW})$$

Where:

(1) TI_{IL} is the amount of the corporation's total taxable income, computed under Illinois law, which is apportioned to Illinois;

(2) TI_{WW} is the amount of the corporation's total taxable income apportionable under Illinois law;

(3) $Sales_{IL}$ is the amount of the corporation's sales within Illinois;

(4) $Sales_{WW}$ is the amount of the corporation's total sales;

(5) $Payroll_{IL}$ is the value of the corporation's payroll in Illinois;

(6) $Payroll_{WW}$ is the value of the corporation's total payroll;

(7) $Property_{IL}$, is the value of the corporation's property located in Illinois;

(8) $Property_{WW}$ is the value of the corporation's total property.

The virtue of using a formula to determine Illinois's share of a multistate corporation's unitary business income can be illustrated by considering Mead. Mead is a multistate corporation whose core business is a vertically integrated manufacturing operation, starting with the growing of timber used in making paper, and culminating with the sale of paper and paper-related products. Mead has activities throughout the country, with property, payroll, and sales located in many states. The formula allows Illinois to answer the otherwise difficult question of how much of Mead's income was sourced to Illinois through the application of a formula. In applying the formula to Mead's operating business income, Illinois determines what share of such income can be properly attributable to the corporation's activities in the [4] State.

A way of understanding the formula is to think of the total operating income generated by Mead as a pizza pie. The formula is used to determine Illinois' slice of the pizza. In determining the size of the pizza pie, only income having some sufficient connection with Illinois can be included.

As a policy matter, the pizza should include only income with which Illinois has some reasonable relationship. For example, if by chance Mead happened to operate a pharmacy in California, having nothing to do with the paper business, the income from that discrete unrelated business would not, as a policy matter, be included in the pizza. Because the pharmacy would be unconnected with Mead's other operating income, Illinois should not be able to tax a

share of the pharmacy's income. Illinois simply has no "hook," connection, or relationship with that income. Accordingly, the income from the pharmacy would not be included in the pizza and the factors of the pharmacy would not enter into the calculation of Mead's Illinois apportionment percentage. The result is that Illinois would not be taxing the out-of-state activities of a business (the pharmacy) that has no relationship to anything taking place in Illinois.[5]

The normative principle that only income that is related to Mead's Illinois business operations can be included in the pizza and apportioned to Illinois is of especial importance to this case. The controversy in this case is whether the income from the liquidation of Lexis/Nexis has a sufficiently close relationship with Illinois so that it can be included in the pizza and apportioned to the State using the formula that applies to the regular operating income generated by Mead.

Not including the liquidation income in the pizza does not mean that Illinois, as a policy matter, can not tax it. To the contrary, the third of the three approaches for determining when a state can tax income, known as specific allocation, applies to income that is not subject to formulary apportionment. Specific allocation assigns certain types of income to a state using non-formulary rules. If formulary apportionment can be viewed as determining a state's slice

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[5] If the pharmacy were located in Illinois, its operating business income could be taxed notwithstanding that there was no relation with Mead's paper business. The pharmacy's operating business income could be taxed because of its relationship to Illinois independent of the relationship of Mead's paper business to the State.

of a pizza, specific allocation can be viewed as giving a scoop of ice cream in its entirety to one state.

[5] Formulary apportionment and specific allocation co-exist. A corporation will apportion its business income and allocate its non-business income.

This case is about whether the income from the liquidation by Mead of Lexis/Nexis should be added to the pizza and apportioned to the State, as the Department wishes, or whether it should be viewed as having nothing to do with Mead's Illinois business, and as being unrelated in any other way to activities in Illinois, and thus subject to the Illinois rules on specific allocation.

One final normative principle that has a bearing on this case is that the apportionment formula should not be inherently or intrinsically arbitrary. It must reflect a reasonable sense of how income is generated. The formula must produce a fair result in light of the taxpayer's activities in the state. In making this determination, separate accounting is often used as a check on the result reached by formulary apportionment. Some ability to check the formula is required because the formula is not based on any scientific or economic theory. The formula grew out of a political compromise between the so-called "origin" states, where manufacturing took place, and the so-called "market" states, where the manufactured goods were sold.

The early apportionment formulas were either one or two factors: property and/or payroll. The market states complained that these factors were too favorable to the origin states and did not fairly share the corporate tax base with the market states. In response to this criticism, a sales factor was added to the apportionment formula.

A formula that reflects a political compromise more than economic theory is unlikely to work well under all circumstances[6] and as a policy matter, some means, like separate accounting, is necessary to determine whether the formula may be overreaching or working improperly under certain conditions.

As applied to the case at issue, the above policy considerations require determining whether the relationship among Illinois, Mead, and Mead's operation and liquidation of Lexis/Nexis justifies Illinois treating the gain on the liquidation as part of Mead's Illinois income. In other words, does a sufficient relationship exist between Mead's Illinois activities and the liquidation income so that such income can be added to the pizza pie and apportioned to [6] Illinois. Alternatively, are there other connections between the liquidation gain and Illinois that could justify Illinois apportioning the income.

IV. Application of the above principles to Mead's liquidation of Lexis/Nexis

Under normative principles of taxation, for Illinois to apportion the gain on Mead's liquidation of Lexis/Nexis, such income must be part of the business income of Mead. There are two ways in which the liquidation gain might be considered to constitute apportionable business income of Mead and both are considered below.

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[6] A Nobel Prize winning economist described the three factor formula as "[t]his simple but arbitrary and capricious formula has all the earmarks of having been concocted by a committee of lawyers who had forgotten anything they ever were taught about statistics or economics." William Vickrey, The Corporate Income Tax in the U.S. Tax System, 73 Tax Notes 597, 602 (1996).

A. Policy considerations regarding whether Lexis/Nexis served an operational function with respect to Mead's Illinois business operations

One principled way for Illinois to apportion the liquidation income is if Mead's ownership of Lexis/Nexis served an "operational function" with Mead's Illinois business operations. From a policy perspective, determining whether an operational function exists requires analyzing the objective characteristics of Lexis/Nexis and its relation to Mead and Mead's activities in Illinois. One example of an operational function would be if Lexis/Nexis generated working capital from its business operations for Mead's paper business. In that event, the business income generated by Lexis/Nexis should be included in Mead's apportionable income.[7] I do not believe, however, that anyone could seriously argue that Mead invested its working capital in Lexis/Nexis or that the income generated by Lexis/Nexis was used by Mead for its working capital.

Another reason why the gain does not serve an operational function is because the sale resulted in the complete liquidation of a separate and distinct line of business.

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[7] The fact that a corporation might have included income from a non-unitary business in its apportionable income does not show that a unitary or operational relationship existed between the businesses. Taxpayers will often include non-unitary income with unitary income because of the simplicity and ease of preparing the tax return. It could be more difficult to carve out and segregate the income and factors of a non-unitary business than simply treating such business as if it were part of the unitary business. To be sure, if the amount of tax at stake is large, a corporation will endure the additional administrative expenses of preparing the computations, but otherwise administrative convenience may outweigh the additional tax that might be paid by treating the non-unitary business as if it were unitary.

Lexis/Nexis was operated as a completely separate line of business because there was no meaningful functional integration, centralization of management, or economies of scale between Mead's unitary paper business and Lexis/Nexis.

Furthermore, there were no synergies between Mead and Lexis/Nexis; they were not [7] interdependent, and they did not share valuable information or the fruits of their respective labors. They did not benefit from the research conducted by the other; there was no sharing of customer lists; there was no sharing of the benefits that come from joint expenditures or purchases; they did not join forces and do more cheaply that which either could do acting on its own; they did not sell to each other at concessionary prices; and there were no joint undertakings to share administrative functions.

The management of Lexis/Nexis did not regularly communicate with the management of Mead. Each business maintained control over its day-to-day operations. Lexis/Nexis was operated separately and independently of Mead, which is not surprising given the disparate nature of their businesses.

Mead and Lexis/Nexis did their own internal accounting. Each had its own in-house legal department. Each hired its own outside lawyers if needed. Each did its own billing, collected its own receivables, and paid its own payables.

Lexis/Nexis and Mead kept separate bank accounts. Lexis/Nexis' funds were not used for either the long-term or short-term financing of Mead. Lexis/Nexis' assets were not directly pledged as collateral for any loan obtained by Mead, and Mead's assets were not directly pledged as collateral for any loan obtained by Lexis/Nexis.

Lexis/Nexis and Mead had decentralized human resources departments, which were independent of each other. Lexis/Nexis and Mead did not share human resource functions. For example, potential employees of Lexis/Nexis applied for employment directly to Lexis/Nexis; potential employees of Mead applied for employment directly to Mead. The power to hire, fire, or layoff, with the exception of a few of the highest level officers, was vested independently in Lexis/Nexis and Mead.

Lexis/Nexis trained its own people and Mead trained its own people. This separate and independent training reflected the dissimilar nature of their businesses.

Lexis/Nexis and Mead did not share transportation vehicles; more generally, they did not share transportation functions.

Lexis/Nexis and Mead did not have shared mail functions. Each business processed its own mail.

Lexis/Nexis and Mead each had their own internal public relations/communications department. These internal departments were self contained and operated independently of [8] the other.

Lexis/Nexis and Mead conducted their own advertising and marketing on a stand-alone basis. There was no integrated sales force. Lexis/Nexis advertising and marketing personnel had no institutional relationship with Mead advertising and marketing personnel.

Lexis/Nexis and Mead did not jointly purchase theft supplies and did not coordinate their buying efforts.

Lexis/Nexis and Mead did not share common facilities. Lexis/Nexis had its own offices in the suburbs many miles

from Mead's location in downtown Dayton. Lexis/Nexis had a cafeteria, an indoor gym, and outside athletic facilities; Mead had none of these.

Lexis/Nexis and Mead conducted no common manufacturing; they did not conduct or share research and development facilities or activities.

Mead and Lexis/Nexis each had an internal audit program, which provided for constant evaluation of the adequacy of, and adherence to, management's established policies and procedures.

Mead did not approve purchase contracts by Lexis/Nexis in its day-to-day business, did not co-sign contracts, did not purchase inventory for Lexis/Nexis, did not assist Lexis/Nexis in purchasing, advertising, conducting its research or development, warehousing, or filling or training personnel. There was no shared credit cards, promotional displays, or joint advertising campaigns. There was no meaningful sharing of goodwill or of common expertise. Lexis/Nexis did not contribute to Mead's paper business nor was Mead's paper business dependent on Lexis/Nexis.

In short, Lexis/Nexis and Mead were managed independently of one another; did their own budgeting, marketing, advertising, sales, accounting, and tax; did their own hiring, training, and firing; had their own legal counsel; had their own human resource departments; had their own public relations and communications departments; did their own research; did not share facilities; and did not engage in joint purchasing or selling. Lexis/Nexis and Mead did not engage in common activities, generated no synergies between each other, were not interdependent, did not share valuable information or the fruits of their

labors, and were conducted essentially as if they were owned by different persons.

The decentralized operation of Mead and Lexis/Nexis is understandable, given that the former was in the paper business and the latter was in electronic publishing. Lexis/Nexis had [9] nothing to do with Mead's paper business and Mead had nothing to with Lexis/Nexis's electronic publishing. Lexis/Nexis was sold as a stand-alone, on-going business, with a workforce in place.

Based on the above facts and applying the governing principles of state tax policy, my opinion is that Mead and Lexis/Nexis were separate businesses. Lexis/Nexis did not contribute to Mead's unitary paper business nor was Mead's unitary paper business dependent on Lexis/Nexis. Accordingly, I conclude that from a policy perspective, Lexis/Nexis is not part of Mead's unitary paper business so that for that reason no nexus exists between Illinois and the gain on the liquidation of Mead's ownership of Lexis/Nexis to justify the Department's apportionment of the gain.[8]

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[8] Even if Lexis/Nexis were part of Mead's unitary paper business, the liquidation gain would not be apportionable in any state that followed the Uniform Division of Income for Tax Purposes Act (UDITPA). The liquidation gain would not satisfy a requirement consistent with UDITPA's that in order to be apportioned, the income must arise "from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." UDITPA, Sec. 1(a). The gain would be allocated under UDITPA's detailed rules. UDITPA, Sections 4-8. Presumably, the income is allocated because apportionment of liquidation gain would be inconsistent with the policies underlying UDITPA's use of formulary apportionment for business income. See the discussion in Part V below.

B. Policy considerations regarding whether Mead had activities in Illinois regarding the liquidation of Lexis/Nexis that would justify treating the income as apportionable income

Normative principles of state tax policy would justify Illinois' treating the liquidation income as apportionable income if Mead's activities in the State were responsible for the sale. Under those circumstances, Illinois might view those activities independently of Mead's business operations in Illinois and treat the income from such activities as generating the liquidation gain. Under this approach, it would be improper to apply Mead's normal apportionment formula to the gain because that formula was calculated using the factors of Mead's Illinois business operations. However, as a policy matter, Illinois could design an appropriate formula to deal with this special case.

It is unnecessary to explore the design of that special formula because as applied to the facts of this case, normative principles of taxation would not justify Illinois apportioning any part of the liquidation gain.

[10] Mead's activities in Illinois had nothing to do with the decision to sell Lexis/Nexis. Mead's Illinois activities were all related to its Illinois business operations and had nothing to do with the liquidation of Lexis/Nexis.

The decision to liquidate Lexis/Nexis was made at Mead's head office and commercial headquarters in Ohio. None of Mead's head office personnel were based in Illinois. None of the activities that took place in Illinois were directly related to Mead's liquidation of Lexis/Nexis, nor was any

person working for Mead in Illinois involved in the decision to sell Lexis/Nexis.

In short, Illinois has no connection with any activity that led to the liquidation income. Accordingly, such income should not be apportioned by Illinois.

V. Illinois' apportioning the gain realized by Mead on the liquidation of Lexis/Nexis would be inconsistent with the policies underlying formulary apportionment

The policy considerations underlying the Illinois three-factor apportionment formula, require that Mead's income from the liquidation of Lexis/Nexis not be apportioned to Illinois. The State's apportionment formula, like any similar formula, works acceptably well for dealing with the everyday business profits of Mead. Those profits can be viewed as being generated by the payroll, sales, and property of the business. Illinois' share of each respective factor can be viewed as helping to generate the ordinary profits of the business. Consequently, there is a matching between the income and the factors that helped generate that income.

In this case, no Illinois personnel or property or, for that matter, any other Illinois activities helped generate the liquidation income that the Department is now seeking to tax. No one in Illinois had anything to do with Mead's decision to sell Lexis/Nexis.

In addition, Lexis/Nexis served no operational function with respect to Mead's paper business in Illinois. Applying the apportionment formula to the liquidation income would give Illinois a slice of that income. Yet from a policy

perspective, nothing occurred in the State that would justify that conclusion.

There is yet another related policy reason why the liquidation proceeds should not be apportioned to Illinois. The Illinois apportionment formula, like all apportionment formulas, is hardly scientific. There is no economic theory or model upon which the formula is based and no principle that dictates, for example, that the receipts factor should be double weighted rather than evenly weighted or even given some other weighting.

[11] One of the reasons, however, that makes the formula workable and acceptable is that as long as it is applied over time to the everyday, recurring business profits, any errors or slippages in the formula are likely to wash out. That is, in one year the formula may overstate the contribution of Illinois labor to generating Mead's everyday profits and understate the contribution of Illinois property. In another year, the formula may overstate the contribution of Illinois property and understate the contribution of Illinois labor. Over time, however, these differences are likely to offset one another. In other words, from the perspective of the taxpayer doing business in the State, the formula produces an acceptable result over time, a kind of "rough justice."

This assumption that imperfections, defects, and weaknesses in the formula will be offset over time cannot hold true with respect to the gain on the liquidation of Lexis/Nexis by Mead. The liquidation gain cannot be viewed as part of Mead's everyday, recurring business profits and thus any defects in the Illinois formula will not be self correcting. The obvious overreaching of the Illinois formula that would result if applied to the liquidation gain

is substantial and cannot be ignored on the grounds that in the future the formula will self correct by underreaching income to which Illinois would otherwise have a legitimate claim.

VI. From a tax policy perspective, a Departmental regulation violates the separation of powers doctrine

You asked me to evaluate from a tax policy perspective whether a regulation[9] issued by the Department violates the separation of powers doctrine. That doctrine requires that any regulation issued by an executive agency not be in conflict with, or in any manner be inconsistent with, a statute enacted by the legislative branch. If a regulation conflicts with, or is inconsistent with, a statute, an executive agency exceeds its powers, which are limited to implementing and interpreting the law as passed by the legislature.

The regulation you asked me to evaluate interprets the sales factor in the apportionment formula described above.[10] Illinois law, as enacted by the Legislature, provides that the term sales means "all gross receipts of the taxpayer not allocated . . ."[11] The regulation at issue, however, provides that in certain instances amounts less than the gross receipts – and sometimes no amounts at all – are to be included in the sales factor.[12]

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[9] 86 Ill. Adm Code Sec. 100.3380(b)(5)(B)

[10] See Part III.

[11] 35 ILCS 5/1501(a)(21).

[12] 86 Ill. Adm Code Sec. 100.3380(b)(5)(B).

[12] This regulation is an example of an executive agency violating the separation of powers doctrine. Rightly or wrongly, the Legislature defined "sales" to include *all* gross receipts of income that is apportioned. The word "all" is unambiguous and leaves no latitude for an executive agency to cherry pick which of a corporation's gross receipts it will include in the sales factor.

"All" means "all." If the Department wishes the statute were to read differently, its approach should not be to usurp the judgment of the Legislature by violating the separation of powers doctrine but rather to request that the law be changed. Any change must come from the Legislature, however, for it is not within the powers of an executive agency to substitute its views for that of the legislative branch.

VII. Conclusion

Lexis/Nexis was in electronic publishing, having nothing to do with Mead's paper business. Mead had no expertise in electronic publishing nor did it attempt to manage Lexis/Nexis. Mead did not purchase Lexis/Nexis in order to park its short-term working capital. Lexis/Nexis was a completely separate business having nothing to do with Mead's unitary paper business. There was no functional integration, centralization of management, or economies of scale between Lexis/Nexis and Mead. Moreover, the sale of Lexis/Nexis resulted in the total liquidation and cessation of a separate line of business, Mead's electronic publishing business. Finally, no one in Illinois had anything to do with the decision to sell Lexis/Nexis.

From a policy perspective, Illinois can apportion the liquidation income only if there is some connection between such

income and Mead's activities in Illinois. A rational relationship must exist between the income Illinois seeks to tax and the activities of Mead in Illinois. I have applied normative principles of taxation to the relationship between Mead, the liquidation income, and Illinois. In my opinion, no connection exists between Illinois and the liquidation gain that justifies Illinois apportioning the gain. Furthermore, apportioning the liquidation gain would be inconsistent with the principles underlying formulary apportionment.

Finally, the Department's regulation that attempts to cherry pick a corporation's gross receipts and include only some, but not all, gross receipts in the sales factor violates the separation of powers doctrine by usurping the judgement of the Legislature.

APPENDIX I

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Part I
Report of Economic Considerations Concerning the Right of Illinois to Tax as Business Income to Be Apportioned the $1.2 Billion Gain Realized by the Mead Corporation on its Sale of Mead Data Central to Reed Elsevier

Part II
Report of Economic and Tax Policy Considerations Concerning the Illinois Department of Revenue's Decision to Modify The Sales Factor's Treatment of Sales by The Mead Corporation of Short-term Working Capital Instruments

Expert Report of
Ferdinand P. Schoettle, LL.D., Ph.D.

[CURRICULUM VITAE INTENTIONALLY OMITTED]

October 2001

Preliminary Matters

1. Retention

I have been retained by counsel for The Mead Corporation ("Mead") as an expert economist with substantial training in matters of state and local taxation to offer my opinion as an economist concerning the right of Illinois to tax as business income to be apportioned the $1.2 billion gain realized by Mead on its sale on December 2, 1994, of Mead Data Central to Reed Elsevier. Also, I have been asked to render an opinion as an economist on the decision by the Illinois Department of Revenue to modify the sales factor's treatment of sales by Mead of short-term working capital instruments.

Mead Data Central normally has been referred to as "Lexis-Nexis." Mead Data Central will be so denominated in the balance of this report.

2. Qualifications

I am Ferdinand P. Schoettle Professor of Law at the University of Minnesota Law School, Minneapolis, MN. My training is in law and in economics. I graduated in 1960 from Harvard Law School *magna cum laude*. In 1983 I was awarded my Ph.D. in economics, also from Harvard. In addition to teaching, I have worked as a tax policy expert both at the U.S. Treasury and at the Brookings Institution and have consulted on tax policy matters for the International Monetary Fund and for the United States General Accounting Office. I have taught, among other places, at the University of Minnesota, at Harvard University, at Uppsala University, Uppsala, Sweden, and at William Mitchell University, St. Paul, Minnesota.

I have been accepted and have testified as an expert-economist witness in a variety of cases involving economic and tax policy issues. A copy of my curriculum vitae is attached.

3. Materials

In addition to those sources cited in the body of the report, I have relied in preparing this report upon the following:

A. The Mead Corporation Annual Reports and various other documents filed with the SEC;

B. Articles from newspapers, from magazines, and from professional journals concerning Mead and Lexis-Nexis;

C. Tax returns filed by Mead between 1988 and 1994;

D. Upon material in my forthcoming book, *State and Local Taxation and Finance* (Lexis Publishing forthcoming 2002);

E. Upon a variety of public finance texts and materials from the World Trade Organization, the U.S. Treasury Department and the Organization for Economic Cooperation and Development;

F. From online research into various sources including the Harvard Business School, the Technical Association of the Pulp and Paper Industry and its serial publications, including the *TAPPI Journal*, and into the *Pulp & Paper Journal* and fact book; and

G. From conversations with users of Lexis-Nexis and with individuals familiar with Mead, with the forest products industry or with the pulp-and-paper business.

Part I
Report of Economic Considerations Concerning the Right of Illinois to Tax as Business Income to Be Apportioned the $1.2 Billion Gain Realized by Mead on its Sale of Lexis-Nexis to Reed Elsevier

A. The Business-Income Issues

I have been asked to familiarize myself with the operating relationships between Mead and Lexis-Nexis so that I may give my opinion on various economic relationships between Mead and Lexis-Nexis. All of these economic relationships concern whether the income realized on the sale of Lexis-Nexis to Reed Elsevier should be allocated or should be apportioned and taxed to Mead as "business income." In general, as shall be detailed below, Mead is a vertically integrated forest products, pulp-and-paper company. Lexis-Nexis is an information services company.

I have been asked to form an opinion as an expert economist on the following economic tests which speak to the relationship between Mead and Lexis-Nexis.

– Was the relationship between Mead and Lexis-Nexis characterized by functional integration, by centralization of management, or by economies of scale?

– Did I find in my investigations of the operating relationship between Mead and Lexis-Nexis any transactions between Mead and Lexis-Nexis that were not undertaken at arm's length; a management role by Mead of Lexis-Nexis which was grounded in its own operational expertise and operational strategy; or that Mead and Lexis-Nexis were engaged in the same line of business?

– Was Lexis-Nexis a discrete business enterprise? Was the relationship between Mead and Lexis-Nexis characterized by any sort of symbiotic relationship by which Mead and Lexis-Nexis contributed to the support of each other in ways not investigated by the above inquiries concerning the relationships of functional integration, centralization of management, and economies of scale?

– Did Mead's acquisition, management and disposition of Lexis-Nexis closely relate from an economic standpoint to Mead's regular trade or whole process of operating its business?

The Business of Mead

Mead was incorporated in 1930 under the laws of the state of Ohio as the outgrowth of a paper manufacturing business founded in 1846. In 1996 Mead officially celebrated its 150th year as a player, indeed a major player, in the forest products, pulp-and-paper business. Mead's principal executive offices and principal executives are at Mead World Headquarters in Dayton, Ohio.

Mead is a vertically integrated forest products, pulp-and-paper company. It owns forests from which it takes timber to produce paper. Mead's principal businesses during the years under investigation, that is 1994 and the years prior to that, can be divided into two parts. First Mead produced pulp-and-paper forest products. These forest products are sold mostly, almost exclusively, to producers such as the printing industry and to producers for packaging. Second, Mead operated a consumer office products business. This business both produced paper-based school and home-office supplies and distributed paper, packaging and business supplies made by other manufacturers. The

product of the office-products business mostly was purchased by final users not for incorporation into a product. In addition, in 1968 Mead acquired Lexis-Nexis, an information services company. The acquisition was an investment in a business that had no connection with the forest products pulp-and-paper business.

Forest Products The Pulp-and-Paper Business

a. The Supply of Pulp for Production of Paper, Packaging and Paperboard

Timberlands

Mead obtains most of its wood requirements from private contractors or suppliers and from Company owned timberlands. The annual wood requirement for Mead's wholly-owned operations is approximately 8,000,000 tons, of which approximately 16% is obtained from timberlands owned or leased by Mead.

As of December 31, 1993, Mead owned or controlled approximately 1,337,000 acres of timberlands in the United States. Approximately 106,000 acres of land are controlled by Mead under long-term agreements which expire at different times through 2027.

Forest Products Affiliates Northwood Forest Industries Ltd. ("Northwood"), which is owned 50% by Mead and 50% by Noranda Forest Inc. ("Noranda"), manufactures bleached softwood kraft pulp at its 1,600 ton-per-day mill in Prince George, British Columbia. Mead has a long-term contract with Northwood pursuant to which Mead is entitled to purchase such of Northwood's pulp production as it may require. The principal markets for its pulp are in the midwestern United States, western Europe and Japan.

Lumber and plywood products are also produced at Northwood's three sawmills and its plywood plant in British Columbia. Northwood has the annual capacity to produce over one billion board feet of lumber and 175 million square feet of plywood (3/8-inch basis). Northwood's solid wood products' operations provide about 670,000 tons (ODT) of wood chips or 70% of the fiber requirements for the Noranda pulp mill. A wood preserving operation also treats lumber and custom treats plywood from other sources.

Northwood Panelboard Company, a partnership owned 50% by Mead and 50% by Noranda and located in Bemidji, Minnesota, has the annual capacity to produce approximately 340 million square feet of oriented structural board (3/8-inch basis).

The Mead Pulp Sales division sells market pulp manufactured by Northwood and by a non-affiliate, Aracruz Celulose S.A. The division maintains one sales office and is represented by affiliates and independent agents in all major pulp-consuming areas of the world. The principal market areas for pulp are in North America, western Europe and Japan. All of the wood products produced by Northwood and Northwood Panelboard Company are sold through a subsidiary of Noranda primarily in North America with approximately 20% sold to export markets.

b. Production by the Mead Paper Divisions – Including the Fine Paper Division, Publishing Paper Division, Gilbert Paper Division, and Specialty Paper Division – of Paper, Paperboard, Coated Paperboard, and Packaging Materials

Paper Production

Mead Fine Paper division produces both coated and uncoated papers for business, printing and specialty uses. The division is also a leading producer of carbonless paper. Mead's Fine Paper division manufactures cut-size copier paper, uncoated and coated papers for commercial printing, form bond and carbonless paper and papers for conversion by others into business forms, and other uncoated papers for conversion by others into such products as greeting cards and bank checks

The Publishing Paper division provides book and magazine publishers, catalog printers and commercial printers with more than 500,000 tons of medium-weight coated paper each year. The division has developed a full line of recycled book and glossy grades in response to customer interest. The Fine Paper division sells papers manufactured by both divisions nationwide, both on a direct basis to printers and converters and through paper merchants, including merchants owned by Mead. Additionally, Escanaba Paper Company, a wholly-owned subsidiary, sells its output to the Publishing Paper division of Mead, which resells the paper directly to publishers and printers. The pulp mills adjacent to the paper mills of these divisions and the pulp mill owned by Noranda produce virtually all of the pulp required for use in these paper mills.

Mead's Gilbert division manufactures cotton content and premium sulfite paper and premium recycled papers,

including bond, banknote, texts and cover, and technical and specialty papers, and sells these products principally through paper merchants, including merchants owned by Mead.

Mead's Specialty Paper division manufactures and sells, primarily through its own sales force, decorative laminating papers. This division also manufactures absorbent, filter, fire resistant, synthetic fiber and other specialty papers. The division's principal customers include manufacturers that serve the building materials, automotive and furniture industries.

The Gilbert Paper division produces high-quality communications papers, including cotton-content bonds, and specialty text and cover papers. Gilbert Paper produces recycled grades.

Packaging and Paperboard Production

The Mead Packaging division designs and produces multiple packaging and packaging systems primarily for the beverage take-home market. The division operates through a network of subsidiaries, affiliates and licensees in the United States, Canada, Europe, Japan, the Far East and Pacific Rim, Mexico, and Latin America. Demand for most beverage packaging is seasonal with inventories being built from November to March for the peak soft drink and beer sales of April through October.

Mead Coated Board, Inc., a wholly-owned subsidiary of Mead, operates a coated paperboard mill near Phenix City, Alabama, and two sawmills in Cottonton, Alabama and Greenville, Georgia, and owns various timberlands in Alabama and Georgia. The subsidiary is engaged primarily

in the manufacture of coated natural kraft products used by the beverage packaging industry and by manufacturers of folding cartons for soaps, food products, hardware and apparel. The entire output of the Phenix City mill is sold by Mead Coated Board, Inc. to the Mead Coated Board division. The division sells approximately 50% of the mill output to the Mead Packaging division. The remainder is sold to a wide range of domestic and foreign carton converters. The division's customers are most concerned about physical strength properties of the paperboard and its quality for reprographics. Mead started up a new CNK(R) paperboard facility adjacent to the Phenix City mill in late 1990, and has constructed additional sheeting facilities in foreign countries to handle a portion of the increased capacity. In 1993, the division commenced operations at new facilities at the Phenix City mill designed to enable the division to meet beverage packaging customer demand for post-consumer recycled content.

The Mead Containerboard division sells standard and special purpose corrugated shipping containers manufactured at eight converting plants located in the Midwestern and Southeastern regions of the United States from raw materials received from outside sources and from the division's Stevenson, Alabama corrugating medium mill. The division also sells corrugating medium from the Stevenson mill to unaffiliated manufacturers of containers.

International Pulp and Paper Sales and Operations

Outside of the United States and Canada, Mead and its affiliates operate a paperboard sheeting facility and are engaged in the manufacture of multiple systems and

folding carton packaging in Europe, Asia and Latin America. Mead also has sales subsidiaries, affiliates, agents or distributors in a number of countries in Europe, Asia, Australia and Latin America.

Production and Distribution of School and Office Products

The Mead School and Office Products division manufactures and distributes a line of school supplies (including filler paper, wirebound notebooks, portfolios and looseleaf binders) as well as a line of office supply products (including envelopes, filing supplies and vinyl folders and binders). The division's products are distributed primarily through mass market retailers, office supply superstores and warehouse clubs. The school supply business is highly seasonal with inventories beginning to be built in the winter and spring for shipment in late spring and summer, while the home and office products portion of the business is generally less seasonal in nature. Manufacturing and distribution is done from seven United States plants/distribution centers, and a small manufacturing facility operated in Nuevo Laredo, Mexico.

Zellerbach, Mead's distribution operation, is a national distribution business which distributes a full line of printing papers, industrial supplies and packaging materials and equipment. These products are distributed through a network of wholesale locations and printer-supply retail outlets. The business units carry inventory or order products against sales orders, depending upon the product and service requirements. Zellerbach distributes not only products of Mead, but also those of several hundred other manufacturers. In the distribution of paper and

other products, competing merchants frequently distribute products of the same supplier.

Lexis-Nexis

Lexis-Nexis markets electronic information services worldwide to corporations, financial institutions, news media, governments and the legal, medical and accounting professions. Principal services include Lexis, a computer-assisted legal research service, and Nexis, a computer-assisted news, financial, marketing and general information retrieval service. Lexis-Nexis's services are distributed to subscribers via subscribers' own computer equipment and custom terminals supplied by Lexis-Nexis.

On May 16, 1994 Mead announced its intention to sell Lexis-Nexis. Mead retained Salomon Brothers to find a buyer. On December 2, 1994 Mead sold Lexis-Nexis to Reed Elsevier for approximately $1.5 billion.

The main reason for the sale, according to those who analyzed the sale at the time and as confirmed by my investigations, was that Mead's capabilities did not include the operation of a computer-based information company like Lexis-Nexis. Because of the visibility of Lexis-Nexis's Lexis and Nexis services and because of the time between the announcement of the desire to sell and the sale itself, many analysts had an opportunity to opine about the reasons for the sale.

Organizational Dynamics reported:

> Despite Data Central's high growth and profitability, it represents only about 12 percent of Mead's total annual revenues. As one analyst put it, 'The demands for information today go beyond

> what a company like Mead can do with the business.' To keep up would divert too many resources from its core businesses - paper, pulp, and other forest products. Carl Long & Mary Vickers-Koch, *Using Core Capabilities to Create Competitive Advantage, Organizational Dynamics,* June 22, 1995.

As *Searcher* reported Mead was not the first to find that owning an information business required an expertise and the ability to make well informed decisions:

> Last of the Amateur Owners
>
> "With the sale of Mead Data Central to Reed Elsevier, content publishers have achieved dominance. No longer will non-information industry companies own or control major search services." [Sales by other owners are here detailed], *Searcher,* Vol. 2, No. 9, November 1994.

The *Dayton Daily News* (Mead is headquartered in Dayton, Ohio) reported an interview with Mead Chairman and CEO Steven C. Mason concerning the decision to sell Lexis-Nexis:

> But while many companies are trying to get on the information highway, Mason is taking Mead back to where it's been. It makes perfect sense to Mason. He believes Mead is more talented at the forest products business.
>
> 'We all have certain talents. We all have certain liabilities. I think we've all a choice to make,' Mason said.
>
> 'Do you maximize your talents, or do you try to overcome your disabilities? My strong view is you maximize your talents and what you can do well.

> It's the same when you think about a Business. You Maximize Your Talents.'
>
> *CEO at Mead Says Decision to Refocus Fits in with Streamlining, Dayton Daily News,* Sunday, May 22, 1994.

A review of the operations of Lexis-Nexis for the few years preceding the sale reveal a host of business problems of Lexis-Nexis to which Mead, the parent company, brought no expertise or guidance. Criticisms of Lexis-Nexis began to surface in 1989, or so. Business problems for Lexis-Nexis included using the Freedom of Information Act to obtain records, the copyright law of cyberspace as it related to the use of West Publishing Company's page numbers, pricing, and technical issues concerning search engines and information organization.

Barbara Quint described the sort of company that might fit well with Lexis-Nexis as follows:

> Just off the top of my head, I suppose the candidates to purchase MDC would come from one of two categories: content-based concerns like publishers or other search services or tool-based enterprises like computer or communications companies.
>
> * * *
>
> Content-heavy companies with lots of print publications moving further and further into the arena of electronic publishing might find MDC an attractive option. Smart publishers should realize by now that one of the key characteristics of the electronic consumer is indifference to sources.
>
> * * *

> Tool-dominant firms like computer or communications companies should appreciate the overnight access to masses of data the acquisition of MDC could give them.
>
> * * *
>
> Either way, the new Mead purchaser should expect to put substantial investment into the service to re-engineer it for the 21st century.
>
> Barbara Quint, *Is Online Ready for Primetime? Speculations on Who Will Acquire Mead Data Central Inc., Information Today,* June, 1994.

B. The Business-Income Issues and My Opinions

I have familiarized myself with the business operations of Mead in order to form an opinion about the operating relationships between Mead and Lexis-Nexis.

My opinion is based both on my own investigation of the relationship between Mead and Lexis-Nexis and upon the relevant literature, such as those opinions expressed above, about Mead's inability to "run" Lexis-Nexis. Both the experts who analyzed the relationship between Mead and Lexis-Nexis and the operating personnel seem to agree on the nature of the relationship between Mead and Lexis-Nexis.

As to the operating personnel, after the decision to sell Lexis-Nexis was announced, Lexis-Nexis president Rodney Everhart was queried about the contribution of Mead to Lexis-Nexis. According to President Everhart:

> "Mead Corporation has been a good parent for the last 25 years. They have nurtured and protected us, but they are not in our business. Technology in

> our field is accelerating. We have greater needs for more technology, content, and funding." *Information Industry Mega-sales: Mead Data Central, Ziff-Davis, et Al; Information Services and Data Base Companies for Sale, Searcher,* July, 1994

As to the relationship between Mead and Lexis-Nexis, based on my investigations I concluded that operational integration between Mead and Lexis-Nexis was virtually zero. Mead kept Lexis-Nexis as a separate business, an investment in a very different business than its own. That separateness was the reason Mead sold Lexis-Nexis. Mead had neither publishing nor computer expertise nor any other line function which it could integrate with Lexis-Nexis. Given these conditions, Lexis-Nexis was truly a "stand alone" company.

My opinions concerning the questions asked of me are as follows.

– Was the relationship between Mead and Lexis-Nexis characterized by functional integration, by centralization of management, or by economies of scale?

In my opinion as an economist the relationship between Mead and Lexis-Nexis was not characterized by functional integration, by centralization of management, or by economies of scale. To the contrary there was a complete absence of functional integration and any economy of scale. Nor was there centralization of management. The legal status of Lexis-Nexis varied from time to time between subsidiary and division. At no time was the management of Mead's primary forest products and pulp-and-paper business active in managing Lexis-Nexis.

– Did I find in my investigations of the operating relationship between Mead and Lexis-Nexis any transactions between Mead and Lexis-Nexis that were not undertaken at arm's length; a management role by Mead of Lexis-Nexis which was grounded in its own operational expertise and operational strategy; or that Mead and Lexis-Nexis were engaged in the same line of business?

In my investigations as an economist I found no transactions between Mead and Lexis-Nexis that were not undertaken at arms length. Indeed, there seem to have been no transactions of note between Mead and Lexis-Nexis. I found that Mead exercised no management role with respect to Lexis-Nexis that was grounded in Mead's own operational expertise and operational strategy. Lexis-Nexis's information services were too far removed from the forest products, pulp-and-paper business for Mead's expertise in the latter to apply to the former.

– Was Lexis-Nexis a discrete business enterprise? Was the relationship between Mead and Lexis-Nexis characterized by any sort of symbiotic relationship by which Mead and Lexis-Nexis contributed to the support of each other in ways not investigated by the above inquiries concerning the relationships of functional integration, centralization of management, and economies of scale?

In my opinion as an economist, Mead and Lexis-Nexis had no symbiotic relationship by which Mead and Lexis-Nexis contributed to the support of each other. The Lexis-Nexis information services business was too different from Mead's forest products, pulp-and-paper business to offer any sort of symbiotic relationship and support for the forest products, pulp-and-paper business.

– Did Mead's acquisition, management and disposition of Lexis-Nexis closely relate from an economic standpoint to Mead's regular trade or whole process of operating its business?

In my opinion as an economist, the management and disposition of Lexis-Nexis did not closely relate from an economic standpoint to Mead's regular trade or whole process of operating its business. The sale bore little relationship to the needs of the forest products, pulp-and-paper business but came about because Lexis-Nexis was too different a business from the forest products, pulp-and-paper business, and too much in need of some expertise and assistance for Mead to comfortably continue to own Lexis-Nexis.

C. Tax Policy and Economic Considerations Governing Illinois Income Taxation of The Mead Company on the Gain from the Sale of Lexis-Nexis

1. Residency and Source – the Two Grounds for Taxing Income

Tax policy and economics often go hand in hand. This is particularly true when considering broader problems such as who can tax particular items of income. From the point of view of both policy and economics there are two factual bases on which to tax income. First, a state may ground its right to tax on the residency or domicile of the taxpayer. The relationship is between the state and the taxpayer that the state seeks to tax, not the taxpayer's income. Because of this relationship with the taxpayer a headquarters state may tax world-wide income. To keep things fair the state should grant a credit for foreign taxes. Second, a

state may ground its right to tax on its being the source of the income. The relationship upon which the state relies is between the income that the state seeks to tax and the state.

About these two principles, those of residence of the taxpayer and source of income as a basis for taxation, there is both theoretical and practical agreement. Reports from the United States Treasury, from the Paris-based Organization for Economic Cooperation and Development and from the European Community embrace and explain these two principals.[1] The U.S. Supreme Court and the Internal Revenue Code follow these principals in assigning the tax base of a multi jurisdictional taxpayer. A general rule incorporating these important premises might read as follows:

> A state may tax residents and domiciliaries on all income wherever earned but should grant appropriate credits for taxes paid to foreign jurisdiction. In addition, a state may tax all income sourced in the taxing jurisdiction whether earned by residents or nonresidents

2. *Residence-based Taxation*

As to residence-based taxation, the state of Mead's corporate headquarters, Ohio, has the sort of relationship with

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[1] European Economic Community, *Report of the Committee of Independent Experts on Company Taxation* (1992) (Ruding Committee); Committee on Fiscal Affairs, Organization for Economic Cooperation and Development, *Taxing Profits in a Global Economy – Domestic and International Issues* (Paris 1991); United States Treasury Department, *Integration of the Individual and Corporate Tax Systems – Taxing Business Income Once* (March, 1992).

Mead that supports taxing Mead on the basis of its domicile and headquarters.

3. Source-of-income based taxation

As to taxation by nondomiciliary states of the $1.2 billion gain to Mead from the sale of Lexis-Nexis, I have found no ground for asserting that this income was business income to be apportioned to Illinois as part of Mead's business operations. From the vantage point of economics and tax policy, for a nondomiciliary state such as Illinois to tax income which is not sourced in the state constitutes a discrimination.

4. The Discriminatory Effects of Taxing Income of Nonresident Taxpayers Not Earned in the State

A state income tax on income of a nonresident which the nonresident has not earned in the state creates a discrimination. If a nonresident who does business in a state must pay taxes not only on income earned in the state but also on income not earned in the state, the nonresident has a higher effective tax rate than a resident and has been discriminated against.

According to my analysis, Mead should pay to Illinois a tax on income it has earned in Illinois. To pay a tax on income not earned in Illinois as a price of doing business in Illinois is to suffer a higher marginal tax rate on income earned in Illinois than the rate applied to other taxpayers, a discrimination.

Stanford economist Dr. Charles McLure accounts for the discrimination of an Illinois tax on Mead's gain from selling Lexis-Nexis in a different way than I do. I focus on

the marginal tax rate. Dr. McLure views the tax as a tax on the factors employed in the state. Dr. McLure details how attempting to tax income not earned in a state as a price of doing business in a state constitutes a discrimination against the factors which the taxpayer has employed in the state to earn income.[2] Dr. McLure writes, for example, concerning the taxation by a state of dividends earned abroad by a nonresident domestic multinational:

> In other words a domestic multinational receiving dividends from abroad would pay a higher effective rate of tax on its economic activities in the taxing state than would an identical firm receiving no such dividends. Discrimination (against in-state payroll, property, and sales) is strongest against those domestic firms that have the most profitable foreign operations and repatriate a substantial portion of their foreign-source income (and thus have it available for domestic investment). Besides being patently unfair, such a policy does not seem very sensible from the point of view of the taxing state.[3]

Dr. McLure's conclusions about what constitutes discrimination apply to any tax by Illinois on Mead's gain from selling Lexis-Nexis.

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[2] Charles E. Mclure, Jr, *Economic Perspectives on State Taxation of Multi Jurisdictional Corporations* (Tax Analysts 1986); *Tax Competition: Is What's Good for the Private Goose Also Good for the Public Gander, Nat'l Tax Jour.* pp. 341-48 (September 1986); *State Taxation of Foreign-Source Dividends: Starting from First Principles*, 86 *TNT* 108-76 (June 2, 1986).

[3] Charles E. McLure, Jr., *State Taxation of Foreign-Source Dividends: Starting from First Principles* and sources cited therein, *Tax Notes*, March 10, 1986, pp. 975-989, 86 *State Tax Notes* 108-76 (Lexis June 2, 1986).

A tax by Illinois on an apportioned part Mead's gain from the sale of Lexis-Nexis would be a discriminatory tax cost made possible only because Mead is an out-of-state, non-domiciliary corporation with income earned in states other than Illinois, income which Illinois by normal standards of tax policy and economics should not tax.

Part II
Report of Economic and Tax Policy Considerations Concerning the Illinois Department of Revenue's Decision to Modify The Sales Factor's Treatment of Sales by Mead of Short-term Working Capital Instruments

I have been asked to give an opinion as an economist and tax policy expert on the application of the regulations of the Illinois Department of Revenue which seem counter to the words of the Illinois statutes. First, the Illinois statutes provide that sales for use in the three-factor formula include total sales:

> (3) Sales factor.
>
> (A) The sales factor is a fraction, the numerator of which is the total sales of the person in this State during the taxable year, and the denominator of which is the total sales of the person everywhere during the taxable year. 35 ILCS 5/304

As noted by Prentiss Willson in *Recent State Corporate Income and Franchise Tax Developments,* 491 *PLE/Tax* 9 (March-April 2001):

> Under UDITPA §15, the sales factor of the three-factor apportionment formula is defined as a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period,

> and the denominator of which is the total sales of the taxpayer everywhere during the tax period. Section 1 of UDITPA defines sales as "all gross receipts of the taxpayer" other than those related to items of nonbusiness income specifically allocable to a particular state. A plain reading of the UDITPA and the MTC's interpretive regulations reveals that the total gross receipts from the sale of intangible assets, including short-term financial instruments, must be included in the denominator of the sales factor.

Second, the Illinois Department of Revenue has modified the statute by regulations. Regulation 86 Ill. Adm. Code Section 100.3380(c)(6) provides:

> c) Sales factor. The following special rules are established in respect to the sales factor in IITA Section 304(a)(3):
>
> * * *
>
> 6) In the case of sales of business intangibles (including, by means of example, without limitation, patents, copyrights, bonds, stocks and other securities), gross receipts shall be disregarded and only the net gain (loss) therefrom shall be included in the sales factor.
>
> Example: In 1990, Corporation A, a calendar year taxpayer, sells stock with an adjusted basis of $98,000,000 for $100,000,000, realizing a federal net capital gain of $2,000,000. Only the net capital gain of $2,000,000 is reflected in A's sales factor for the taxable year ending December 31, 1990.

From a tax policy prospective, this is a major change that should be analyzed carefully and be politically approved

before being made. Illinois is a financial center with many sales of bonds, stocks and other securities. Changing the treatment in the apportionment formula to be accorded sales of bonds, stocks and other securities could have a major impact on the tax liability of various taxpayers and accompanying effects on the Illinois economy.

I have not done sufficient economic analysis to report to the Court what effect the change in the sales factor sought by the Illinois Department of Revenue might have on the economy of Illinois. I can, however, report that economists have done many studies on the effects of the sales factor. Analysis of such effects can be complex. "Obvious" conclusions reached without expert economic analysis may be incorrect. For instance, consider the conclusions reached by James K. Smith in his recent article, *Guide to State Corporate Income Tax Apportionment – Part I,* 2000 *STT* 239-28 (November 20, 2000). The author noted:

> The long-term impact of a change to a state's apportionment formula is more difficult to predict because it depends on a number of factors. In addition to the composition of the state's corporate taxpayers, the long-term impact to the state also depends on how the state's corporations react to the change and how other states react. A state is most likely to boost long-term tax revenues if other states do not change their apportionment formulas in response and, as a result, corporations move their property and payroll into the state making the change. On the other hand, a state is less likely to boost long-term tax revenues when other states respond by making similar changes to their apportionment formulas and, as a result, corporations decide not to increase property and payroll investment in the state making the initial change.

Economists have mostly focused their analyses of the sales factor on the issue of the effects of adopting a single-factor sales formula. See, for instance, Austin Goolsbee, Edward Maydew and Michael S. Schadewald, *What Would Happen if Wisconsin Adopted A Single-Factor Sales Apportionment Formula?,* 2000 *STT* 49-23 (March 13, 2000); Kelly Edmiston, *Optimal Factor Weights in State Corporate Income Tax Apportionment Formulas,* 1999 *STT* 108-27 (June 7, 1999); Allen Maury and Laird Graiser, *New Mexico's Corporate Income Apportionment Formula – Effects of Double-weighting the Sales Factor,* 93 *STN* 21-23 (February 2, 1993); Bharat N. Anand and Richard Sansing in *The Weighting Game: Formula Apportionment as an Instrument of Public Policy,* 53 National Tax Journal 183 (2000).

The exact issue on which the Illinois Department of Revenue has acted without legislative approval has been a major political battle ground. The Multistate Tax Commission proposed a change to the Uniform Division of Income for Tax Purposes' regulations that is similar in spirit to that announced by the Illinois Department of Revenue. A hearing on the proposed regulation was held Thursday, July 8, 1999. No further action has been taken. As Prentiss Willson, *supra,* notes:

> The MTC's proposed regulation provides compelling evidence that despite the apparent clarity of the statutes and the regulations, the issue of whether gross receipts, rather than net profits, from the sale of intangibles must be included in the sales factor is quite controversial. The controversies are playing out in the administrative arena and in the courts.

In my opinion, such a change in a major accounting variable should be made by the legislature, not by an unelected administrative agency.

Ferdinand P. Schoettle
October 2001

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No. 06-1413

In the Supreme Court of the United States

THE MEADWESTVACO CORPORATION, SUCCESSOR IN INTEREST TO THE MEAD CORPORATION, PETITIONER,

v.

ILLINOIS DEPARTMENT OF REVENUE, DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE, AND TREASURER OF THE STATE OF ILLINOIS, RESPONDENTS.

On Petition for Writ of Certiorari to the Appellate Court of Illinois

BRIEF IN OPPOSITION

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QUESTION PRESENTED

The Due Process and Commerce Clauses permit a State to tax a fraction of the income earned by a nondomiciliary corporation from a capital transaction that served an operational function for the business and did not arise from a mere passive investment. *See Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 785, 787 (1992); *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 180 n.19 (1983). The Illinois Appellate Court applied this fact-intensive "operational function" test to allow Illinois to tax a portion of the gain realized from Petitioner's sale of its Lexis/Nexis division—whose growth Petitioner nurtured from its inception through both management expertise and capital contributions, repeatedly restructured for its own tax benefit, and held out to the government, its own shareholders, and the general public as part of its general business operations. Does the appellate court's application of this "operational function test" in this case conflict with this Court's precedent or other state high-court decisions, warranting the exercise of this Court's discretionary review?

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BRIEF IN OPPOSITION

STATEMENT

1. The Tax Dispute

A. Petitioner misstates or omits many of the crucial facts of this case, beginning with its assertion in the Question Presented that Lexis/Nexis operated as an independent, nonunitary business of Petitioner for 26 years. In fact, for the tax year in question, and for the previous five years, Petitioner treated Lexis/Nexis as a part of its unitary business group for the purpose of Illinois income tax filings and payments. It was not until Petitioner realized the gain from Lexis/Nexis's sale that Petitioner altered its position and began to claim that Lexis/Nexis was not part of its unitary business group.

From 1988 to 1993, Mead reported over $3.8 billion in income, of which over $800 million was from Lexis/Nexis, on its Illinois combined income tax returns. Vol. 4, C842.[1] Over these years, Petitioner also reported over $4.4 billion in business expense deductions on its Illinois combined income tax returns, of which over $680 million was attributable to Lexis/Nexis. *Id.* In 1994, Petitioner reported Illinois sales of over $338 million, of which almost $47 million was contributed by Lexis/Nexis. Pet. App. 4a.

B. Petitioner's relationship with Lexis/Nexis, however, began 26 years before the 1994 tax year. *Id.* at 2a. In 1968,

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[1] Citations to the record on appeal will be by volume number and page. The common law record is designated with the prefix "C," i.e., Vol. ___, C___, and the report of proceedings with the prefix "RP," i.e., Vol. ____, RP ___.

Petitioner purchased Data Corporation for $6 million. *Id.* At the time, Data Corporation was developing ink jet printing technologies and a full text information retrieval system for computers. *Id.* By 1973, the information retrieval system had become Lexis/Nexis. *Id.* But Lexis/Nexis did not become profitable until the end of the 1970s; until then it was supported by Petitioner's capital contributions. *Id.*; *see also* Vol. 9, RP 68, 92.

Throughout the 1980s and 1990s, Petitioner continued to approve major capital expenditures for Lexis/Nexis to expand its computer center and central processing units. Pet. App. 3a. In the 1980s, impressed by its strong position in electronic publishing, Petitioner rejected a plan to sell Lexis/Nexis, and instead "encouraged management to continue to develop growth plans for this division." Vol. 7, C1502.

Also, in the 1980s and 1990s, Petitioner treated Lexis/Nexis alternatively as a corporate division or a corporate subsidiary. Pet. App. 2a. In 1980, Lexis/Nexis was merged into Petitioner as a division; in 1985, it was reincorporated separately; in December 1993, it was merged again. *Id.* at 2a-3a. Petitioner undertook the mergers in order to realize substantial tax savings, in the last case by permitting Petitioner to utilize operating loss carry forwards that otherwise would have expired. *Id.* at 13a; Vol. 7, C1741; Vol. 8, C1753.

C. In its 1993 annual report, Petitioner touted itself not only as "'one of the world's largest manufacturers of paper,' and a leader in packaging" but also as "'the developer of the word's leading electronic information retrieval services for law, patents, accounting, finance, news and business information.'" Pet. App. 3a. On its 1993 10-K form, filed with the Securities and Exchange Commission, Petitioner likewise described itself as engaged in the business of electronic publishing. Pet. App.

4a; Vol. 6, C1330. Consistent with this pronouncement, the 10-K filing listed Lexis/Nexis among Petitioner 's "business segments," rather than among its 'investees.' Pet. App. 3a-4a. Petitioner also listed "LEXIS" and "NEXIS" as trademarks under which it "conducts its business" and which were "of material importance to [its] business." Vol. 6, C1334.

When it announced plans to sell Lexis/Nexis, Petitioner stated in a press release that it had "'grown'" Lexis/Nexis from its inception as a "'small legal data-base into the word's premier provider of online legal information and the pioneer in computer-assisted news retrieval.'" Pet. App. 4a. (quoting Vol. 4, C930). In describing the sale in its 1994 annual report, Petitioner again emphasized that it had "'grown[n] this business'" and decided to use much of the gain realized on Lexis/Nexis's sale to, *inter alia*, buy back stock.[2] *Id.* (quoting Vol. 6, C1277).

D. Petitioner and Lexis/Nexis's day-to-day business operations were separate in some respects. *Id.* at 3a. Since 1980, Petitioner and Lexis/Nexis had been housed in buildings 15 miles apart. *Id.* They did not share personnel, purchasing functions, manufacturing or warehousing, they were described as having separate corporate cultures, and there were no favorable intercompany transactions. *Id.* But Petitioner did make a nightly cash sweep of Lexis/Nexis's bank accounts, and Petitioner invested the money for Lexis/Nexis's benefit "in a manner decided by" Petitioner. *Id.*

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[2] There is a typographical error in the Illinois Appellate Court's decision, immaterial to the present case. The decision states that $350,000 of the gain was used to buy back stock (Pet. App. 4a); in fact, the amount was about $350 million, and an additional $725 million of the gain was used to reduce corporate debt (Vol. 4, C842).

2. Proceedings Below

Respondent Illinois Department of Revenue, made two audit findings adverse to Petitioner for the 1994 tax year: that Petitioner 1) improperly classified the gain from the sale of Lexis/Nexis as income not subject to apportionment by the State and therefore not subject to Illinois income tax (even in part), and 2) improperly included almost $5 billion in gross receipts on the sale of short-term financial instruments in its sales factor denominator, rather than the $1.9 million of actual interest income. Pet. App. at 5a. The trial court affirmed the auditor's finding against Petitioner on the second issue on summary judgment, and Petitioner's challenge to the first finding proceeded to a bench trial. Pet. App. 5a-6a.

The trial court considered stipulated facts and heard testimony. Petitioner retained three tax law professors to testify as expert witnesses on the question of income apportionability: Richard Pomp, Walter Hellerstein, and Ferdinand Schoettle. Pet. App. 30a-31a, 48a-103a. Over Respondent's objection, the trial court allowed the testimony "for the [witnesses] opinions," but the court would not accept the "bases for the opinions" as substantive evidence. *Id.* at 34a. Nevertheless, the professors opined as to their view of the appropriate legal standard, applied the facts to that standard, and concluded that under their standard Lexis/Nexis was neither unitary with Petitioner, nor an operational asset. *See* Vol. 9, RP 124-57, 165-92, 205-19.

The Illinois Department of Revenue's auditor also testified on income apportionment (Pet. App. 31a), although Petitioner misstates his testimony. Petitioner states that the auditor testified that "there was no functional integration between Petitioner and Lexis/Nexis, *nor was there any operational relationship between the businesses.*" Pet. 8 (emphasis in original). In fact, the auditor specifically denied Petitioner's

assertions that he never found functional integration, centralized management or economies of scale. Vol. 10, RP 10-11. And on the operational relationship question, the auditor testified only that Lexis/Nexis was not acquired in order to supply necessary raw materials as part of Petitioner's supply chain. *Id.* He did not testify that there was no operational relationship between the two companies. *Id.*

Based on the stipulated facts and the testimony, the trial court found that "it was not clear that there was no operational purpose" to Lexis/Nexis. Pet. App. 38a-39a. Accordingly, the trial court upheld Respondent Department of Revenue's conclusion that the gain realized on Lexis/Nexis's sale was apportionable business income subject to Illinois income tax. *Id.* at 6a. The appellate court affirmed in an unpublished, nonprecedential order. Pet. App. 12a-14a, 43a. In addition to affirming the trial court's ruling that the gain was constitutionally apportionable, the appellate court also affirmed the trial court's findings that the gain was business income under Illinois law, and that Petitioner could not, under Illinois law, use its total gross receipts from the sale of short-term financial instruments to reduce its Illinois apportionable income. *Id.* at 1a-22a.

Respondents successfully moved to publish the appellate court's decision because all of the decision's holdings are important—not just the court's ruling on the constitutionality of apportionment. *Id.* at 42a-47a. In the motion, Respondents pointed out that the appellate court's rulings on the state law sales factor issue and business income issue could potentially impact over a dozen pending lawsuits. *Id.* at 44a, 46a-47a. In contrast, the constitutional apportionment issue was important because the present case provided a useful counterpoint to an earlier appellate court decision, *Hercules, Inc. v. Dep't of Revenue*, 753 N.E.2d 418 (Ill. App. Ct. 2001), which, on a

different set of facts, held that the gain from the sale of a capital asset was not constitutionally apportionable under the operational function test. Pet. App. 44a-45a.

REASONS FOR DENYING THE PETITION

The petition does not satisfy this Court's criteria for issuing a writ of certiorari. *See* Sup. Ct. R. 10. Petitioner has not identified a conflict with this Court's decisions establishing the operational function test. The appellate court relied on the legal standard articulated in *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992), which all agree provides the proper constitutional test. *See* Pet. App. 11a (stating that "the relevant inquiry under the operational function test focuses on the "'objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State'") (quoting *Allied-Signal*, 504 U.S. at 785); Pet. 2, 12 (citing *Allied-Signal*). Petitioner 's only real criticism of the appellate court's decision is that it misapplied the proper standard to the facts of this case.

Nor is the appellate court's decision in conflict with decisions from high courts of other States. This Court has noted that the constitutional question of income apportionment is "quite fact sensitive," which by its nature allows courts "to reach[] divergent results" in "different factual circumstances." *Allied-Signal*, 504 U.S. at 785. Other state courts have also recognized the fact-intensive nature of the operational function test, and have applied it with results that vary with the facts of each case. This is not a conflict; it is the inevitable result of applying a fact-sensitive rule to factually distinct transactions.

I. The Illinois Appellate Court's Decision Does Not Conflict with this Court's Decisions Establishing and Applying the Operational Function Test.

This Court has held that the Due Process and Commerce Clauses of the Federal Constitution prevent States from taxing extraterritorial values earned by nondomiciliary corporations. *See ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982); *see also Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 165-66 (1983). In order to apportion multistate income earned by a nondomiciliary corporation, there must be some rational relationship between the "opportunities, benefits, or protection conferred or afforded by the taxing State," and the activities that the State seeks to tax. *See F.W. Woolworth Co. v. Taxation & Revenue Dep't*, 458 U.S. 354, 371-72 (1982) (quotations omitted); *see also Allied-Signal*, 504 U.S. at 772. To exclude income from state tax apportionment, the taxpayer has "the distinct burden of showing by clear and cogent evidence that the state tax results in extraterritorial values being taxed." *Container Corp.*, 463 U.S. at 164 (punctuation omitted); *see also Allied-Signal*, 504 U.S. at 787 (stating that taxpayer must prove "that the income was earned in the course of activities unrelated to those carried out in the taxing State") (punctuation omitted).

A nondomicilliary business's multistate income may be constitutionally apportioned if the multistate operation is run as a single unitary business or if the asset or transaction a State seeks to tax served an operational function. *See Allied-Signal*, 504 U.S. at 783, 787. This latter, operational function test "focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State." *Id.* at 785 (citing *Container Corp.*, 463 U.S. at 180 n.19); *see also id.* at 787. A State may not constitutionally apportion income earned by a mere passive investment in another State.

Allied-Signal, 504 U.S. at 788. Unlike a passive investment, an operational relationship provides the necessary link between the State and the activity the State seeks to tax sufficient to satisfy due process and the Commerce Clause. *Id.* at 785, 787-88.

In distinguishing between an operationally related asset and a passive investment, this Court has looked for objective evidence of management's role in ensuring the particular asset's growth and at the asset's role in the taxpayer's business operations in the taxing State. *See id.* at 789; *Container Corp.*, 463 U.S. at 180 n.19; *see also ASARCO*, 458 U.S. at 323. While recognizing that the distinction is "quite fact sensitive," *Allied-Signal*, 504 U.S. at 785, this Court has provided some nonexclusive illustrations of multistate business investments that serve an operational function: 1) income earned on short-term investments used to provide working capital, *see id.* at 787-88; *ASARCO*, 458 U.S. at 325 n.21; and 2) income on investments designed to provide a stable supply of a key ingredient, *see Allied-Signal*, 504 U.S. at 788 (citing *Corn Prods. Refining Co. v. Comm'r*, 350 U.S. 46, 50-53 (1955)). This Court has also described one fact pattern where an investment does not serve an operational purpose: a passive investment acquired pursuant to a long-term strategy of corporate acquisitions and divestitures. *Allied-Signal*, 504 U.S. at 788.

Again, given the fact-intensive nature of the inquiry, nothing in *Allied-Signal* suggests that these examples are exclusive, as Petitioner implies. *See* Pet. 12-13, 16, 19. Moreover, neither *Allied-Signal* nor prior decisions provide specific criteria to consider under the operational function test. (A point on which Petitioner's *amicus*, Council on State Taxation, agrees (*see* COST Br. at 4-5) but that Petitioner fails to acknowledge.) Certainly, nothing in *Allied-Signal* supports Petitioner and its *amicus*'s assertion that "the focal point" of the Court's analysis is "whether the asset was utilized directly in the selling

company's business."[3] Pet. 12-13, COST Br. at 5. Rather, the focus of the apportionment inquiry remains the flow of value between the business units and management's role in the business unit's affairs. *See Container Corp.*, 463 U.S. at 180 n.19; *accord Allied-Signal*, 504 U.S. at 788.

In deciding whether income is apportionable, this Court has considered facts such as the degree and exercise of actual control by the taxpayer over the business asset in question. *See, e.g.*, *Allied-Signal*, 504 U.S. at 788 (noting that 20.6% ownership interest was not enough even for potential control, which weighed against apportionment); *Container Corp.*, 463 U.S. at 177 n.16 (noting that potential control is not dispositive but is relevant to apportionment determination, distinguishing *Woolworth*, 458 U.S. at 362, which held that mere potential to control business affiliate was not dispositive as to whether affiliate's income was apportionable); *ASARCO*, 458 U.S. at 322-23 (unasserted majority interest weighed against finding that related businesses were unitary). The source of the business unit's financing is also relevant to the apportionment determination. *See Woolworth*, 458 U.S. at 366 (fact that each subsidiary was responsible for obtaining its own financing

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[3] The "utilized directly in the selling company's business" standard that Petitioner would impose lends itself to circularity. Petitioner assumes that it was not in the electronic publishing or electronic information retrieval business in order to argue that the facts that the appellate court relied on were irrelevant and that Lexis/Nexis was not an operational asset of its business. *See* Pet. 3-5. Under this Court's precedent, however, the facts define the scope of the business; the scope of the business is not predetermined in a manner that controls which facts are relevant. *See Mobil Oil Co. v. Comm'r of Taxes*, 445 U.S. 425, 440-42 (1980); *Exxon Corp. v. Wis. Dep't of Revenue*, 447 U.S. 207, 223-24 (1980).

weighed against finding that out-of-state affiliate's income was apportionable). Public statements of corporate purpose or intent, on which investors may rely, are also material. *See Container Corp.*, 463 U.S. at 180 n.19 (noting that evidence of managerial role in subsidiaries' business was found in taxpayer's statements in annual reports).

As other decisions of the Illinois Appellate Court applying *Allied-Signal* illustrate, these factors sometimes favor a holding for the multistate taxpayer. *See Home Interiors & Gifts, Inc. v. Dep't of Revenue*, 741 N.E.2d 998, 1004-05 (Ill. App. Ct. 2000) (relying on financial statements reporting that certain accounts were "investments" in analyzing whether income was apportionable); *Hercules, Inc. v. Dep't of Revenue*, 753 N.E.2d 418, 426-27 (Ill. App. Ct. 2001) (considering inability to control joint-venture as factor weighing against finding of operational relationship). Petitioner does not dispute that *Allied-Signal* articulated the operational function standard (Pet. 12, 19), and cannot dispute that the appellate court expressly applied *Allied-Signal*, Pet. App. 11a (stating that "the relevant inquiry under the operational function test focuses on the '"objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State'") (quoting *Allied-Signal*, 504 U.S. at 785), just as it did in *Hercules* and *Home Interiors & Gifts*. In this case, the appellate court simply concluded that, under *Allied-Signal*, Petitioner did not prove by clear and cogent evidence that the taxing authority had overreached the constitutional boundaries.

The appellate court weighed evidence showing the extent of Petitioner's actual exercise of control over Lexis/Nexis and its exercise of discretion to finance and control Lexis/Nexis's growth. Pet. App. 12a-14a. The court also relied on evidence of Petitioner's use of Lexis/Nexis to take advantage of net loss carry forwards that it could not otherwise obtain, as well as

evidence that Petitioner held itself out to financial regulators, shareholders and potential investors as engaged in the business of electronic publishing and electronic information retrieval, and that it considered its trademarks in Lexis/Nexis to be material business assets. *Id.* at 13a. No such evidence was present in *Allied-Signal*, or in cases like *ASARCO*, or *Woolworth*, where this Court found that income was not apportionable.

The appellate court's decision that under these facts Petitioner failed to prove by clear and cogent evidence that Lexis/Nexis was *not* an operational asset is thus perfectly consistent with this Court's holdings. Petitioner and its *amici* can only manufacture a conflict by mischaracterizing the appellate court's decision. Contrary to Petitioner's claim (Pet. 13, 15), the court did not rely solely on the fact that Lexis/Nexis was 100% owned by Petitioner (*see* Pet. App. 12a-13a) (reciting evidence used to conclude that Petitioner failed to meet its burden of proof). Nor are ownership percentages immaterial, as *amicus* COST claims. COST Br. at 6. In *Woolworth*, this Court held only that the potential for control was not dispositive, *see* 468 U.S. at 362, and in *Container Corp.* this Court clarified that such evidence was indeed relevant, *see* 463 U.S. at 177 n.16.

Nor was it improper for the appellate court to consider Petitioner's 10-K filings and the manner in which Petitioner held itself out to the public, investors and government regulators. *See id.* at 180 n.19 (evidence of management's role taken from annual reports). *Amicus* Gannett provides an extended discussion of what it means to include a company as a business segment on a 10-K statement, arguing that such inclusion is governed by independent Financial Accounting Standard No. 131. Gannett Br. at 6-7. Petitioner had every opportunity to make this argument before the appellate court but failed to do so,

meaning that this line of argument is forfeited.[4] *See Illinois v. McArthur*, 531 U.S. 326, 334-35 (2001). Moreover, nothing in *amicus* Gannett's discussion suggests that Petitioner 's choice between characterizing Lexis/Nexis on its 10-K statement as a business segment rather than as an investment, or its treatment of Lexis/Nexis trademarks as material to its business was meaningless. (At a minimum, potential investors should be able to rely on the fact that when a public corporation states that it is in the electronic publishing business, it means what it says.) Gannett's real objection is to the manner in which the appellate court weighed this evidence.

Amicus Gannett also mischaracterizes the record in arguing that Petitioner's nightly cash sweep amounted to a "constructive dividend" of Lexis/Nexis's earnings, which cannot be used as a basis for apportionment without undermining the "'unitary-business limitation.'" Gannett Br. at 6 (quoting *Woolworth*, 458 U.S. at 364 n.11). From December 1993 through Lexis/Nexis's 1994 sale, it was Petitioner's division, not its corporate subsidiary—and the 1994 sale was an asset sale, not a stock sale. Pet. App. 3a-4a. It is difficult to see how, and Gannett has cited no authority that, a cash sweep of a corporate division's earnings can be construed as a dividend, constructive or otherwise.

Further, when Lexis/Nexis was a corporate subsidiary, the cash yielded nightly from the sweep of Lexis/Nexis's bank accounts was invested for Lexis/Nexis's benefit, but at Petitioner's direction. *Id.* at 3a. Thus, on this record, Gannett's

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[4] The appellate court noted that Petitioner failed to provide "relevant legal authority" to support its argument that the trial court improperly considered the annual reports and 10-K statements. Pet. App. 13a. Petitioner therefore forfeited these arguments as a matter of Illinois law. *See People v. Ward*, 215 Ill. 2d 317, 332 (2005); Ill. Sup. Ct. Rule 341(h)(7).

contention that funds were commingled and that the cash sweep amounted to a constructive dividend is, at best, raw speculation. *See, e.g., Mills v. Internal Revenue Serv.*, 840 F.2d 229, 235 (4th Cir. 1988) (holding that payments between corporate entities are constructive dividends only if there is a direct benefit to the shareholder above and beyond its interest in the corporation). Moreover, from Gannett's description, its own cash management system, in which funds from various business units apparently are commingled, appears distinct from Petitioner's cash sweeps described in the record. Gannett Br. at 5 n.2. How Gannett's particular cash management system impacts its state-court litigation can thus only be imagined under its present account of the facts. In any case, Petitioner did not make this "constructive dividend" argument to the appellate court, or introduce any facts to prove it, and the argument should not be raised now by an *amicus*. *See McArthur*, 531 U.S. at 334-35 (arguments not made below are waived); *see also Container Corp.*, 463 U.S. at 164 (it is *taxpayer*'s burden to prove by clear and cogent evidence that extraterritorial values are being taxed).

Petitioner and *amicus*'s attempt to diminish the tax benefits Petitioner realized through its manipulation of Lexis/Nexis's business form is another improper post hoc attempt to reweigh the evidence. Pet. 14; COST Br. at 7. Petitioner was not using Lexis/Nexis simply for vague "tax advantages" but for the concrete benefit of claiming net loss carry forwards, which would otherwise expire. *Cf. In re Envirodyne Indus.*, 354 F.3d 646 (7th Cir. 2004) (Posner, J.) (rejecting taxpayer's attempt to unitize corporate subsidiaries through common parent in order to apply losses incurred by one line of subsidiaries to unrelated profitable subsidiaries).

In the end, Petitioner and *amici* are complaining about how the appellate court weighed the facts and applied the facts to the legal standard. *See, e.g.*, COST Br. at 4 ("It is the application of

this standard that should determine the outcome of this case."). Indeed, the heart of *amicus* COST's brief is devoted to reweighing the facts on which the appellate court relied. *See, e.g.*, COST Br. at 6-8 (noting that "[s]trategic planning about asset holdings . . . supports a conclusion" that the asset is an investment," and "100% ownership of a subsidiary . . . . may be for operational synergy; others serve strictly [as] an investment purchase."). Contesting how the state appellate court weighed the facts and applied the settled law to them does not create a conflict or inconsistency with this Court's decision in *Allied-Signal* or any other of this Court's decisions.[5] Further review by this Court is unwarranted.

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[5] *Amicus* COST's general complaint that the appellate court's reasoning will subject its members to multiple and discriminatory taxation on investments (*id.* at 2, 9) misses the mark. Whether income is subject to multiple or discriminatory taxation is a function of the fairness of the apportionment formula, not the fact of income apportionment. *See Container Corp.*, 463 U.S. at 169-71. States have wide latitude in their selection of apportionment formulas, *see Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 274 (1978), and the type of three-factor formula used by Illinois during the 1994 tax year, *see* 35 ILCS 5/304(a) (1994), is "something of a benchmark against which other apportionment formulas are judged," *Container Corp.*, 463 U.S. at 170. Moreover, while Petitioner did argue in the appellate court that the inclusion of Lexis/Nexis's gain in Illinois' apportionment formula unconstitutionally distorted the amount of income attributable to Illinois (*see* Pet. App. 17a-18a), it did not raise this contention in its Question Presented (*see* Pet. i).

II. The Decision of the Intermediate Appellate Court in this Case Does Not Conflict with Decisions of Other States' High Courts.

Petitioner has not identified any direct conflict with other States' high court decisions. Like this Court in *Allied-Signal*, 504 U.S. at 785, other state courts have noted that the operational function test is fact-intensive, *see Alaska Dep't of Revenue v. OSG Bulk Ships, Inc.*, 961 P.2d 399, 413 (Alaska 1998); *see also Citicorp N. Am., Inc. v. Franchise Tax Bd., Inc.*, 100 Cal. Rptr. 2d 509, 532 (Ct. App. 2000) (taxpayer failed to produce evidence that out-of-state real estate rental income was unrelated to in-state business). And other state courts have applied criteria similar to those on which the Illinois Appellate Court relied.

In *Hoechst Celanese Corp. v. Franchise Tax Bd.*, 22 P.3d 324, 328-30 (Cal.), *cert. denied*, 534 U.S. 1040 (2001), the California Supreme Court found that a gain realized from the partial reversion of the taxpayer's pension trust fund was operational income, despite the fact that the taxpayer did not hold legal title to trust fund assets. The income was apportionable under the operational function test because the taxpayer funded the plan with apportionable business income, managed the plan by choosing its management and guiding its overall investment strategy, and because the plan made better use of the taxpayer's employees, a business-related resource. *See* 22 P.3d at 344-45. The *Hoechst Celanese* court thus relied on many of the same facts that the Illinois Appellate Court did—capital support, investment oversight and control—in reaching its conclusion that the trust fund was the taxpayer's operational asset. *See id.* at 345. There is no conflict between the present case and *Hoechst Celanese*, as Petitioner suggests. Pet. 21-22.

In *Citicorp N. Am.*, 100 Cal. Rptr. 2d at 531-32, the California Court of Appeal held that a banking and financial services conglomerate's gain from the sale of out-of-state office property that generated business income from rentals to unrelated third parties was constitutionally apportionable under the operational function test. The court noted that the taxpayer failed to produce evidence that its real estate holdings were divorced from its financial services business. *Id.* As in *Hoechst Celanese*, this Court denied the certiorari petition. *See Citicorp North Am., Inc. v. Franchise Tax Bd.*, 533 U.S. 963 (2001).

Like the rental income in *Citicorp N. Am.*, Lexis/Nexis's income contributed to and was treated as Petitioner's business income prior to its sale. And like the taxpayer in *Citicorp N. Am.*, Petitioner has not proven that Lexis/Nexis had nothing to do with Petitioner's activities in Illinois. These two cases do not conflict. *Cf. Jim Beam Brands Co. v. Franchise Tax Bd.*, 34 Cal. Rptr. 3d 874, 878-82 (Ct. App. 2005) (holding that gain realized from liquidating sale of subsidiary that contributed to production of business income was also apportionable business income under state law).

Nor does *OSG Bulk Ships* conflict with the present case, as Petitioner also contends. Pet. 21. That case did not involve the sale of a corporate asset. Rather, the parties stipulated that the income in question was investment income. The issue on appeal was whether that investment income could be apportioned if it did not contribute to working capital. The Alaska Supreme Court held that for investment income to be "operational" it had to contribute to working capital. 961 P.2d at 412-14. In short, that case involved the treatment of investment income specifically, and nothing in the decision foreclosed apportioning the gain from the sale of a business asset, as the Illinois Appellate Court did here.

Pennzoil Co. v. Dep't of Revenue, 33 P.3d 314, 318 (Or. 2001), *cert. denied*, 535 U.S. 927 (2002), also did not involve a capital transaction directly. There, the Oregon Supreme Court held that the State could tax a portion of an oil company's settlement proceeds from a lawsuit arising out of the failed acquisition of another oil company. The court held that because the target of the acquisition owned significant oil reserves, and those reserves were important to the taxpayer's in-state business, the proceeds qualified as operational income under the *Corn Products* doctrine, recognized by this Court in *Allied-Signal*, 504 U.S. at 788. But that case does not limit the operational function test to *Corn Products*-type fact-patterns, as Petitioner suggests. Pet. 21-22. In fact, the Oregon Supreme Court applied the *Corn Products* doctrine quite broadly, citing no evidence that potential oil reserves were necessary to supply the in-state motor-oil blending business.

Nor do the series of *Hercules* cases that Petitioner cites conflict with the present case. *See* Pet. 19-20 (citing *Hercules, Inc. v. Comptroller of Treasury*, 716 A.2d 276 (Md. 1998); *Hercules, Inc. v. Comm'r of Revenue*, 575 N.W.2d 111 (Minn. 1998)). As the Illinois Appellate Court's own *Hercules* decision illustrates, these decisions provide an appropriate counterpoint to the present case, for they applied many of the same factors that the Illinois Appellate Court applied here. *See Hercules v. Dep't of Revenue*, 753 N.E.2d 418 (Ill. App. Ct. 2001).

In *Hercules*, the taxpayer spun off a former division into an independent joint-venture company—one in which the taxpayer did not hold a majority interest, that it could not control, had no operational ties to, and dealt with at arm's length. 753 N.E.2d at 426-28. Not only did the Minnesota and Maryland high courts agree that under this set of facts the State could not apportion the gain from the sale of the business asset, *Hercules, Inc.* 575 N.W.2d at 116-17; *Hercules, Inc.*, 716 A.2d at 112-15, but so did

the Illinois Appellate Court, 753 N.E.2d at 430. The instant case does not conflict with these decisions. It is the result of applying the same legal standard to a different set of facts.

This Court has accorded great flexibility to the States in deciding the question of the constitutional apportionability of income. The taxpayer's burden to show that its constitutional rights were infringed "*is never met merely by showing a fair difference of opinion*," and this Court will not "re-examine, as a court of first instance, findings of fact supported by substantial evidence." *Container Corp.*, 463 U.S. at 175-76 (emphasis in original). As a result, this Court expects that different factual circumstances will lead to different results. *Allied-Signal*, 504 U.S. at 785.

As the above discussion of the case law illustrates, this Court's expectation has been realized. The Illinois Appellate Court and other state courts have ably applied *Allied-Signal* and reached different results in different factual circumstances. In applying the *Allied-Signal* standard, the Illinois Appellate Court and other state courts have correctly examined the "objective characteristics of the income-producing asset's use and its relation to the taxpayer and its activities in the taxing state," *Hoechst Celanese*, 22 P. 2d at 345 (quoting *Allied-Signal*, 504 U.S. at 785) (punctuation omitted); (Pet. App. 11a), to determine whether the necessary "minimum connection exists between the taxing state and the corporation's business activities," (Pet. App. 10a) (citing *Allied-Signal*, 504 U.S. at 772), or whether the income instead was earned in the course of unrelated activities, *see Pennzoil*, 33 P.3d at 318 (citing *Allied-Signal*, 504 U.S. at 787).

In the end, all that Petitioner and *amici* can muster is a complaint that in this case the appellate court did not properly weigh the evidence and misapplied that evidence to this Court's

legal standard. But such a contention does not mean that the appellate court's decision cuts loose the apportionment principles from any limitations. *See* COST Br. at 5. And a disagreement with the Illinois Appellate Court's application of the facts to the law does not provide a basis for this Court's review.

CONCLUSION

The petition for writ of certiorari should be denied.

Respectfully submitted,

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In The
Supreme Court of the United States

MEADWESTVACO CORPORATION,
successor in interest to THE MEAD CORPORATION,

Petitioner,

v.

ILLINOIS DEPARTMENT OF REVENUE, DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE, AND TREASURER OF THE STATE OF ILLINOIS,

Respondents.

On Petition For A Writ Of Certiorari To The Appellate Court Of Illinois

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STATEMENT OF THE CASE

Respondents allege that Petitioner misstated or omitted "many of the crucial facts of this case" in its Petition. Brief in Opposition ("Br. in Opp.") 1. This is not true. Respondents are attempting to create factual issues where none exist. As the appellate court recognized, the facts in this matter "are essentially undisputed." App. 2a.

Respondents point to Petitioner's statement that "Lexis/Nexis operated as an independent, nonunitary business of Petitioner for 26 years." *Id.* In support of their assertion that this is misleading, Respondents point to the fact that Lexis/Nexis was included in Petitioner's unitary business group for Illinois income tax filings and allege that it was not until Petitioner realized the gain from Lexis/Nexis that it "altered its position." *Id.*

First, the trial court in this matter found that "Mead and Lexis/Nexis are not unitary." App. 39a. The trial court specifically found that the fact that Lexis/Nexis was included in Petitioner's unitary business group for Illinois income tax filings was not a controlling factor in determining whether a unitary relationship existed. App. 38a.

Moreover, the appellate court set forth as fact that Petitioner included Lexis/Nexis in its unitary business group as the result of a settlement. Although Petitioner disagreed with Respondents' assertion during a previous audit that Lexis/Nexis be included in its unitary business group, in order to settle the disputed audit, Petitioner complied with Respondents' position on the issue until the sale of Lexis/Nexis in 1994. App. 3a. Pursuant to these facts, Petitioner's position that it did not have a unitary

relationship with Lexis/Nexis has been consistent. It is improper for Respondents to assert that Petitioner has misstated the record and "altered its position" on this issue when the record clearly demonstrates otherwise.

As yet another example of a fact apparently omitted by Petitioner, Respondents set forth taxes paid and deductions taken in Illinois attributable to Lexis/Nexis for the period from 1988 through 1993. Br. in Opp. 1. As noted by the appellate court, Petitioner has never disputed that Lexis/Nexis had nexus with, and was subject to tax in, the State of Illinois. Rather it has always been Petitioner's contention that "the taxation of the intangible income, including the gain on goodwill, from the Lexis/Nexis sale was unconstitutional." App. 11a. Therefore, the amounts paid as taxes or taken as deductions are not relevant to the issue before this Court.

The remainder of the facts recited by Respondents in its Statement – Petitioner's capital contributions to Lexis/Nexis, Petitioner's ability to change the form of Lexis/Nexis from division to subsidiary, Petitioner's receipt of tax advantages from its ownership of Lexis/Nexis, Petitioner's inclusion of Lexis/Nexis in describing its business in annual reports and Forms 10-K, Petitioner's investment of Lexis/Nexis' excess cash for the benefit of Lexis/Nexis – all of these factors were addressed in the Petition filed herein. Br. in Opp. 1-3; Pet. 4-5, 7. Indeed, the crux of Petitioner's argument is that such factors amount to nothing more than those actions that would be taken by any conscientious investor in watching over its investment and therefore are not relevant to the issue of whether it had an operational relationship with Lexis/Nexis.

PROCEEDINGS BELOW

With regard to Respondents' description of the proceedings below, Petitioner finds references to the additional issues not before this Court irrelevant, and for the most part does not object to the remainder of the statements with the exception of Respondents' assertion that Petitioner has mischaracterized the testimony of the auditor. The cross-examination of the auditor included the following questions and responses:

Question:	And then you say Mead Corp. and its sub, Lexis-Nexis, were in the same general line of business. Was that your finding, that they were in the same general line of business?
Auditor's Response:	All but Lexis-Nexis. In other words, everybody but Lexis-Nexis is in the same line of business.
Question:	So, Lexis-Nexis is in a different line of business?
Auditor's Response:	That's correct.
*	* *
Question:	Is it correct that in the course of your audit you never found functional integration between Lexis-Nexis and Mead, did you?
Auditor's Response:	No.

* * *

Question:	Isn't it correct that you never found an operational relationship, and I'll give you an example of the Corn Products case. I believe Professor Hellerstein gave the example of somebody, say Mead, who would buy 20 percent of a forest products company because they would have, then, 20 percent of their product to go make their paper?
Auditor's Response:	Right.
Question:	You never found that type of relationship between Lexis-Nexis and Mead?
Auditor's Response:	No.

Record on Appeal, Vol. 10, 6, 10-11. The auditor did not find either functional integration or an operational relationship between Petitioner and Lexis/Nexis. Furthermore, the auditor concluded that Petitioner and Lexis/Nexis were not in the same line of business. The record speaks for itself.

Finally, in response to the quote set forth in the Petition wherein Respondents' stated that the appellate court decision "provides such crucial guidance on a recurring issue," and that "the decision is significant," Respondents do not deny the importance of this case, they

merely again raise issues that are no longer a part of this case. Pet. 11, 18; Br. in Opp. 5-6.

REASONS FOR GRANTING THE PETITION

I. WITHOUT FURTHER REVIEW, THE ILLINOIS DECISION WILL EFFECTIVELY OVERTURN THE OPERATIONAL TEST SET FORTH IN *ALLIED-SIGNAL*

Petitioner's argument is not that it disagrees with the application of the correct law to the facts in this case as asserted by Respondents, but rather that the appellate court applied the incorrect law. As noted in the Petition, not only did the appellate court utilize factors that have never been held by this Court to apply to a determination of an operational relationship, but also the factors utilized by the appellate court have many times not even been utilized by this Court in reaching a determination as to whether a unitary relationship exists.

For example, Respondents assert that whether tax advantages were had and descriptions of business activities in annual reports are factors that are to be considered in determining whether an asset has an operational relationship with a business. Br. in Opp. 10-11. Respondents state that "[n]o such evidence was present in *Allied-Signal*, or in cases like *ASARCO*, or *Woolworth*, where this Court found that income was not apportionable." Br. in Opp. 11.

Contrary to Respondents' assertion, however, and as noted in the Petition, in *Allied-Signal* this Court ignored descriptions of business activities in annual reports that

the Supreme Court of New Jersey had relied upon in reaching the conclusion that an operational relationship existed. *Bendix Corp. v. Director, Div. of Taxation*, 592 A.2d 536, 538-40 (N.J. 1991), *rev'd sub nom. Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992). Moreover, in *F.W. Woolworth Co. v. Taxation & Revenue Department of New Mexico*, 458 U.S. 354, 369 (1982), "Woolworth's published financial statements, such as its annual reports, were prepared on a consolidated basis" and this Court still found that the income from the affiliates was not apportionable to New Mexico. Finally, other than a mention of ASARCO providing income tax preparation services to Southern Peru, there is nothing in the *ASARCO* decision indicating this Court considered either tax advantages or descriptions of business activities in reaching its decision. *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 321 n.17 (1982). Thus, contrary to Respondents' assertion, this is a point raised in a brief which is supported by citation to relevant authority. Br. in Opp. 11.

Respondents argue that there is no support for Petitioner's position that the "focal point of this Court's analysis for the finding of an operational relationship has been whether the asset was utilized directly in the selling company's business, or was utilized as a short-term investment to fund the day-to-day operations of the selling company." Pet. 12-13; Br. in Opp. 8-9. However, this is the same line of inquiry Respondents urge is the relevant inquiry under the operational test, *i.e.*, an inquiry that "focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the State." *Allied-Signal*, 504 U.S. at 785; Br. in Opp. 10. The characteristics of the asset's use and its relationship

to the taxpayer have to do with how directly the asset is connected to the taxpayer's business.

Furthermore, Respondents' assertion that the relevant inquiry when discussing the operational nature of an asset is whether there is a flow of value between the businesses and whether management takes an active role in the running of the other business is incorrect. Br. in Opp. 9. That is the relevant inquiry when determining if a unitary business exists. With the exception of *Allied-Signal*, the cases cited in support of this proposition by Respondents are all cases where the issue was whether a unitary business existed – *Container, Woolworth, and ASARCO*. Moreover, even if that were the proper analysis, there was no flow of value between the businesses, nor did Petitioner take an active role in the running of Lexis/Nexis. The trial court determined that "Mead and Lexis/Nexis were not unitary," App. 39a, and the appellate court in this matter found that:

> Mead and Lexis/Nexis maintained separate day-to-day business operations, and they did not share personnel or make joint purchases. Since 1980, Lexis/Nexis had its own building about 15 miles from Mead's Dayton headquarters. There was no centralized manufacturing or warehousing of products, and Mead and Lexis/Nexis were described as having different corporate cultures. There were no favorable intercompany transactions.

App. 3a.

II. WITHOUT FURTHER REVIEW, THE ILLINOIS DECISION, WHICH DECIDES AN IMPORTANT FEDERAL QUESTION, WILL STAND IN CONFLICT WITH DECISIONS OF OTHER STATE COURTS OF LAST RESORT

Petitioner relies upon its Petition for showing that the decision of the appellate court is in conflict with decisions of other state courts of last resort. With regard to the one additional case discussed by Respondents, *Citicorp North America, Inc. v. Franchise Tax Board*, 100 Cal. Rptr. 2d 509 (Cal. Ct. App. 2000), *cert. denied,* 533 U.S. 963 (2001), Petitioner refers this Court to its discussion of *Hoechst Celanese Corp. v. Franchise Tax Board*, 22 P.3d 324 (Cal.), *cert. denied,* 534 U.S. 1040 (2001), a later case decided by the Supreme Court of California.

CONCLUSION

Contrary to the Respondents' assertion that Petitioner has only shown that the appellate court misapplied the factors utilized by this Court in reaching a determination as to whether an asset has an operational relationship with a business, Petitioner has shown that the appellate court applied factors never before applied by this Court. Petitioner and the *amici* have shown that the appellate court's decision will effectively overturn the operational test set forth by this Court over 15 years ago in *Allied-Signal*. Furthermore, Petitioner has shown that if not reviewed, the appellate court decision will be in conflict with decisions from the highest courts of other states on this important federal constitutional question.

The Petition for a Writ of Certiorari should be granted.

Dated: July 27, 2007

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IN THE

Supreme Court of the United States

MEADWESTVACO CORPORATION, successor in interest to THE MEAD CORPORATION,
Petitioner,

v.

ILLINOIS DEPARTMENT OF REVENUE, DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE, and TREASURER OF THE STATE OF ILLINOIS,
Respondents.

On Petition for a Writ of Certiorari to the Appellate Court of Illinois

BRIEF OF *AMICUS CURIAE* COUNCIL ON STATE TAXATION IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether the "operational" test of *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), bars a non-domiciliary state from taxing gain realized on the sale of a non-unitary business when that business was unrelated to the selling company's business and was not utilized as an investment by the selling company to generate funds for its operations.

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IN THE

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Petitioner,

v.

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Respondents.

On Petition for a Writ of Certiorari to the Appellate Court of Illinois

BRIEF OF *AMICUS CURIAE* COUNCIL ON STATE TAXATION IN SUPPORT OF PETITIONER

INTEREST OF *AMICUS CURIAE*

This brief *amicus curiae* in support of petitioner is filed on behalf of the Council On State Taxation ("COST") representing many of the largest businesses in our nation's state and local economies.[1]

[1] No counsel for a party authored this brief in whole or in part, and no person or entity other than *amicus curiae* has made a monetary contribution to the preparation or submission of this brief. Written consent of all parties to the filing of this brief has been obtained and filed with the Clerk of this Court.

COST is a non-profit trade association formed in 1969 to promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. COST represents nearly 600 of the largest multistate businesses in the United States, including companies in every industry. COST's members are concerned that Illinois' effort to tax the gain on the sale of a non-unitary, non-operational line of business will subject taxpayers to inconsistent and unconstitutional taxation. COST's members are also concerned that left unchecked Illinois' approach to taxing all income will lead other states to adopt similarly unsound theories of taxation, exacerbating multiple taxation of the same income.

The present case involves Illinois' attempt to tax the gain on Petitioner Mead's sale of its investment in Lexis/Nexis, an independent, non-unitary business which it held as an investment for twenty six years. While the decision below concluded that Lexis/Nexis and Mead did not share a unitary relationship, it also concluded that the gain on sale of the business was apportionable income subject to tax. COST members routinely buy and sell investment subsidiaries, lines of business, and divisions of their companies. The frequency of these transactions and the large dollar amounts at stake (in this case a $1 billion gain) hyper-accentuate the importance of the rules for determining whether gains on such sales are apportionable income subject to tax by non-domiciliary jurisdictions. Certainty and protection against multiple taxation of such gains are critically important issues to all of COST's membership.

SUMMARY OF ARGUMENT

Illinois has violated this Court's rules for determining whether income from the sale of an asset can be subjected to tax by a non-domiciliary state. As set forth by this Court in *Allied-Signal, Inc. v. Director, Division of Taxation,* 504 U.S. 768 (1992), non-domiciliary states are only allowed to tax

income from the sale of a non-unitary asset if the asset served an operational function. Left unchallenged, the Illinois decision will eviscerate this Court's operational test. Virtually all income will thus become subject to apportionment and multiple taxation by the states.

ARGUMENT

I. *ALLIED-SIGNAL* APPLIES AN OPERATIONAL TEST FOR TAXATION OF NON-UNITARY INCOME

The taxation of multistate activity, and in particular the rules by which non-domiciliary states may tax income from the liquidation or sale of major assets, has routinely attracted the attention of this Court. This Court's guidance sets the constitutional boundaries for fair taxation of businesses whose activities cross state lines. By doing so the Court has created a set of rules which protect interstate commerce from discrimination and which provide clear guidance such that state and local taxes do not unlawfully impede economic growth. While the rules of state taxation were not always clear, this Court brought a measure of certainty to the arena of state tax in the landmark case of *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425, 439 (1980), where it clarified that "[The] linchpin of apportionability in the field of state income taxation is the unitary-business principle." See also, *Exxon Corp. v. Department of revenue of Wisconsin*, 447 U.S. 207 (1980).

Two years later the concept of the unitary business enterprise was further clarified in two cases decided on the same day, *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982) and *F. W. Woolworth v. Taxation & Revenue Department of New Mexico*, 458 U.S. 354 (1982). In these two decisions the Court struck down attempts by two states to tax an apportioned share of income which was—similar to the present case—derived from a non-unitary business. In

reaching its decision the Court indicated that actual, and not merely potential, control of another enterprise is required to establish a unitary relationship, and further emphasized that a unitary inquiry requires a review of three factors: "(1) functional integration; (2) centralization of management; and (3) economies of scale." *Id.* at 362, 364.

At a high level these three cases stand for the proposition that apportionability of income is tied directly to whether the income stems from a unitary function of the business sought to be taxed; in other words a state need not attempt to isolate the intrastate income-producing activities from the rest of the business; it may tax an apportioned sum of the corporation's multistate business if the business is unitary. *Allied-Signal* at 778.

Ten years after *ASARCO* and *Woolworth*, and in response to an effort by New Jersey to argue that all income was subject to apportionment[2], this Court upheld the unitary principle, acknowledging an exception where income from a non-unitary enterprise might be apportionable—if "the capital transaction serve an operational rather than an investment function." *Allied-Signal* at 787. It is the application of this standard that should determine the outcome of this case.

In providing the possibility that non-unitary income could be subject to apportionment this Court articulated the nature of the operational test. While *Allied-Signal* does not list a series of specific factors to consider under the operational test, its analysis is clear that the test focuses on whether the

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[2] In *Allied-Signal*, this Court specifically declined the invitation of the State of New Jersey that "the unitary business principle must be abandoned in its entirety, arguing that a nondomiciliary State should be permitted 'to apportion all the income of a separate multistate corporate taxpayer.'" *Allied-Signal* at 784. The Court rejected the idea that all income of an enterprise should be taxable in every state; an idea which it acknowledged would obliterate the apportionable income concept. *Id.*

asset generating the income was utilized directly in the selling company's business, or whether it was utilized for investment purposes to fund the day-to-day working capital and operations of the selling company. *Id.* at 787, 789-90. Only if one of these functions is met can the income be determined to be operational and subject to tax by a non-domiciliary jurisdiction.

II. ILLINOIS BLURS THE OPERATIONAL AND INVESTMENT TESTS OF *ALLIED-SIGNAL* SUCH THAT ALL INCOME WOULD BE OPERATIONAL

The Appellate Court of Illinois erroneously adopted its own test in place of the operational analysis required by *Allied-Signal*. Although the trial court concluded that the operations of Mead and Lexis were not unitary—a ruling left undisturbed—the Appellate Court of Illinois focused on a series of inappropriate and result-oriented factors intended to accomplish implicitly what New Jersey attempted explicitly in *Allied-Signal*—to eliminate any limitations on apportionment.

As described below, the factors utilized by Illinois to conclude that the gain was apportionable disregard the necessary operational focus—whether the asset was used in the same line of business as the company that sold it or whether the asset was analogous to working capital. By substituting its own factors the Illinois court instead focuses the analysis on criteria that would support the conclusion that the gain on sale of *any* investment subsidiary be subject to apportionment. In a rather self-serving fashion the court below evaluates factors that exist as a matter of normal business practice for hundreds of thousands of corporate investments and which make the elimination of non-apportionable income a fait accompli.

Application of Illinois' factors (instead of this Court's operational requirement) will result in treating all but an insignificant minority of business holdings as subject to tax. As demonstrated below, the Appellate Court of Illinois considered factors which have no bearing on the operational test adopted by this Court. Each of the stated reasons for the holding simply blur the operational and investment tests together in an attempt to conclude that all investment income is apportionable. The Opinion of the Appellate Court of Illinois ("*Op.*"), includes the following factors which, as also set out below, have no bearing on whether the asset being held is operational:

(i) "Mead considered Lexis/Nexis in its strategic planning, particularly in the allocation of its resources." *Op.* at 117.

Strategic planning about asset holdings, including a determination of where a parent company should invest additional resources, reflects analytic thought about the asset owner's financial investment strategy and thus supports a conclusion that the corporate holding serves an investment purpose, not an operational purpose.

(ii) "Mead was 100% owner of Lexis/Nexis." *Op.* at 118.

100% ownership of a subsidiary does not create a unitary relationship, as was conceded below, nor does it help demonstrate that the asset serves an operational purpose. Corporations buy and sell subsidiaries, divisions and lines of business every day. Some such transactions may be for operational synergy; others serve strictly an investment purchase—to hedge against market conditions, or simply to invest excess capital. The fact that Mead owned Lexis/Nexis for many years does not demonstrate an operational relationship, but, consistent with Mead's Annual Report and 10-K, demonstrates that Mead had made a long term investment in

Lexis/Nexis and was not using it as a form of short term working capital.

(iii) "Mead developed Lexis/Nexis by contributing capital support until it became profitable." *Op.* at 118.

The fact that an investor would contribute additional working capital to one of its corporate holdings demonstrates sound investment management designed to guard the investment from capital shortfalls or promote the growth of that investment. This factor demonstrates an investment management strategy, not an operational relationship.

(iv) "Mead continued to approve major capital expenditures by Lexis/Nexis." *Op.* at 118.

The fact that an investor retains decision-making power over major capital expenditures again demonstrates sound investment management designed to ensure that the investment owner's interests are adequately protected.

(v) Mead "manipulated Lexis/Nexis' business organization, treating it as either a division or a corporate subsidiary". *Op.* at 118.

Switching corporate form or structure is done thousands of time each day by companies throughout the country. The tax and non-tax related reasons for routine changes in corporate structure are nearly infinite.

(vi) "Mead retained tax benefits and control over Lexis/Nexis' excess cash." *Op.* at 118.

It should go without saying that investors put their money in investments with the goal of retaining tax benefits and excess cash produced by the investment.

(vii) Mead, in its 1993 annual report, "identified itself as 'the developer of the world's leading electronic information retrieval services for law, patents, accounting, finance, news and business informa-

> tion'"; and, in its "1993 10-K form, Mead described itself as engaged in electronic publishing and included Lexis/Nexis in its discussion of business segments rather than its 'investees.'" *Op.* at 118.

Corporate Annual Reports and 10-K's aim to provide shareholders with information about the company itself as well as information about all of its investment holdings. The fact that the Annual Report and 10K identified the company "itself" as being in the electronic information business is simply a reflection of the fact that the report discloses all significant holdings, divisions and lines of business of the combined group of related entities. This cannot be a factor in determining whether the corporate holding is operational.

* * * *

The factors used, when taken together, describe activities that any investor would sensibly conduct to protect asset value. As such, those factors blur the operational analysis inextricably with investment function analysis. At the heart of the Illinois court's "operational" analysis, in light of common investment practices, is a goal of subjecting to tax the gain on sale of *any* investment if the state can show that the investor exercised normal due diligence; exercised some level of control; engaged in strategic planning; continued expansion of the investment if necessary; controlled how the investment is held or titled; decided whether to retain tax benefits or excess cash created by the investment; and, worst of all, if the investor managed to do well by the investment and noted that fact in its Annual Report or 10-K.

The "operational" activities that Illinois considers relevant are synonymous with normal investment practices reflecting the due diligence necessary to protect and nurture the value of any investment. This type of stewardship is not symptomatic of the control and utilization inherent in the operational relationship required by *Allied-Signal*.

Illinois should not be allowed to blur operational analysis simply by substituting factors that demonstrate sound investment practice. To do so obliterates the operational standard altogether and will have the effect of subjecting investment gains from non-unitary holdings to multiple and discriminatory taxation.

CONCLUSION

Allied-Signal is a critical case establishing the outer reach of a state's ability to tax income by limiting it to those activities that bear a substantial relationship to the operations of the investor corporation in the state.

The decision of the Appellate Court of Illinois undercuts that standard, exposing companies to unlimited apportionment and multiple taxation, and creating uncertainty among the states as to their proper constitutional limitations.

The petition for writ of certiorari should be granted.

Respectfully submitted,

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Petitioner,

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Respondent.

On Petition For A Writ Of Certiorari To The Appellate Court Of Illinois

AMICUS CURIAE BRIEF IN SUPPORT OF PETITIONER, MEADWESTVACO CORPORATION, successor in interest to THE MEAD CORPORATION, SUBMITTED ON BEHALF OF GANNETT CO., INC.

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INTEREST OF THE *AMICUS CURIAE*[1]

Pursuant to Rule 37.2 of the Rules of this Court, Gannett Co., Inc. ("Gannett") respectfully submits this brief as *amicus curiae* in support of Petitioner. The issues presented are of great importance to Gannett and many similarly situated companies. Gannett is the parent corporation of an affiliated group of corporations and other business entities with operations in the United States, United Kingdom, and elsewhere. Gannett is a leading international news and information company. In the United States, the company publishes 90 daily newspapers, including *USA TODAY*, and nearly 1,000 non-daily publications. The company is the largest newspaper publisher in the United States, and also operates Internet sites offering news and information customized to the market served. In addition, Gannett carries on publishing operations in the United Kingdom, operating as Newsquest, including 17 paid-for daily newspapers and almost 300 non-daily publications. Gannett's other principal business segment is its broadcasting segment that operates 23 broadcast television stations in the United States with a market reach of over 20.1 million households.

As a publicly traded corporation, Gannett must file various public documents with the Securities and Exchange Commission ("SEC"). Like all public companies, Gannett must determine its business segments and report

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[1] No counsel of a party authored this brief in whole or in part, and no person or entity, other than the *amicus curiae*, made a monetary contribution to the preparation or submission of this brief. All parties have consented to the filing of this brief, and the letters of consent of both Petitioner and Respondents have been filed with the Court pursuant to Rule 37.2(a).

these in its public financial statements filed with the SEC. Currently, Gannett has determined that its largest business segment is newspaper publishing and its other business segment is television broadcasting. Although newspaper publishing has always been Gannett's largest segment, in the past it has operated other reportable business segments, including outdoor advertising and cable television.

Like any responsible parent corporation, Gannett approves its subsidiaries' capital budgets and may contribute capital to its newspapers, television stations, and internet sites whether they are in start-up mode or mature. Likewise, Gannett maintains a cash management system to facilitate sound financial accounting controls for cash and accurate quarterly reporting of Gannett's cash position in SEC filings.

Gannett is presently involved in litigation in a number of States, including Illinois, Maine, and Montana. This litigation presents questions regarding the proper state income tax treatment of capital gains recognized by a subsidiary of Gannett that disposed of a cable television business that Gannett acquired in December 1995 as part of its acquisition of Multimedia, Inc., and held for a little over four (4) years before selling the assets to Cox Communications, Inc. in January 2000. The issue is also the subject of controversies that may be litigated in several additional States.

Gannett believes that the Illinois Appellate Court's decision below improperly interpreted this Court's operational function test in a way that effectively removes the unitary business principle as a meaningful limitation on the reach of States to tax the income of non-domiciliary

taxpayers. This is a field in which Gannett has a major interest.

ARGUMENT

I. INTRODUCTION

One of the several functions of management when serving as responsible corporate stewards for shareholders of a public company is financial oversight and transparent financial reporting. Among the common oversight roles of management are approval of capital budgets, cash management, and financial statement reporting in accordance with promulgated standards. The Illinois Appellate Court below thought these common stewardship activities caused a subsidiary corporation to serve an operational function for its parent corporation.

Since this Court's decision in *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), at least 19 of the 46 States and the District of Columbia that impose a corporation income tax now define and tax apportionable, business income solely or significantly in relation to the full extent permitted by the United States Constitution. This trend necessarily implicates the Court's decisions in *Allied-Signal, F.W. Woolworth Co. v. Taxation & Revenue Department of New Mexico*, 458 U.S. 354 (1982), *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982), and *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983), as the only limits on State determinations of apportionable income. As a result, the improper and expansive interpretation of this Court's jurisprudence by the Illinois Appellate Court impacts the interests of Gannett and other similarly situated public

companies in a substantial number of States beyond Illinois. Petitioner's Petition for Writ of Certiorari should be granted so that the core purpose and meaning of the unitary business principle as a limitation on State taxing authority can be preserved.

II. AN OPERATIONAL FUNCTION SHOULD BE DETERMINED BY FOCUSING ON WHETHER THE ASSET IS OPERATIONALLY CONNECTED TO BUSINESS ACTIVITIES CONDUCTED IN THE TAXING STATE.

A. Capital Expenditure Approval, Capital Contributions, and Cash Management Serve Financial Oversight Functions and do not Render an Out-of-State Business an Operational Function of In-State Business Activities.

The Illinois Appellate Court's decision flaunts the purpose of the unitary business principle. The principle is a limitation on the reach of a State to tax the income or gain of a non-domiciliary taxpayer. *Allied-Signal*, 504 U.S. at 778. Thus, "... the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State" is determinative of whether an asset served an operational, or investment, function. *Id.* at 785. Accordingly, whether an asset served an operational function should be determined by focusing on whether the asset is operationally connected to the business activities conducted in the taxing State. Petitioner's approval of Lexis/Nexis capital expenditures, contributions of capital, segment reporting of Lexis/Nexis in its public company financial statements, and cash management system, in addition to being common to any public company, did not, by themselves or in combination, create any

operational connection of Lexis/Nexis to Petitioner's Illinois business activities.

For example, the Illinois Appellate Court emphasized Petitioner's cash management system.[2] A cash management system is critical to a public company and promotes accounting control of cash to facilitate accurate quarterly reporting of the company's cash position in SEC filings. In addition, for tax purposes the cash advances resulting from the operation of a cash management system are normally treated as constructive dividends by the operating subsidiary to the parent corporation to the extent of the subsidiary's earnings and profits (and as a return of capital to the shareholder to the extent in excess of the subsidiary's earnings and profits). Alternatively, the cash advances may be treated as a loan if, in substance, the advances are in the nature of a loan. *Alterman Foods, Inc. v. United States*, 611 F. 2d 866 (Ct. Cl. 1979); *Laidlaw Transportation, Inc. v. Commissioner*, T.C. Memo. 1998-232 (1998); *New York Times Sales, Inc. v. Commissioner of Revenue*, 667 N.E. 2d 302 (Mass. Ct. App. 1996). Thus, when properly viewed, a cash management system constitutes the commingling of dividend income received from

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[2] Petitioner, like Gannett, operated a centralized cash "sweep" management system. Under Gannett's system, cash receipts are collected by operating units at the local level, deposited into their own separate bank accounts, and then "swept" to a concentration account of the parent corporation using the Automated Clearing House ("ACH") system, which is operated by the Federal Reserve. When a local operating unit needs cash for payroll or other business expenditures, the "sweep" is reversed. Such a system should be contrasted with a cash receipts and disbursements method in which all cash receipts (payments from customers) and disbursements (payments to vendors, suppliers, and personnel) are processed by a parent corporation or headquarters office using a central bank account.

subsidiaries. This Court previously held that a commingling of dividend income cannot be the test of whether a unitary business existed because that "subverts the unitary-business limitation," *F.W. Woolworth*, 458 U.S. at 364, n. 11. Likewise, when the Illinois Appellate Court relied on Petitioner's cash management system as serving an operational function it subverted the unitary business limitation.

B. Segment Reporting Serves a Financial Oversight, not Operational, Function.

In accordance with Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information* (1997), issued by the Financial Accounting Standards Board ("FAS 131"), all "public business enterprises" are required to report certain information about operating segments in public financial statements filed with the SEC. The objective of FAS 131 is to provide information about the different business activities in which a public company engages and the different economic environments to help users of the public company's financial statements. FAS 131 became effective for fiscal years beginning after December 15, 1997, and superseded Statement of Financial Accounting Standards No. 14, *Financial Reporting for Segments of a Business Enterprise* (1976) ("FAS 14"), and related financial accounting pronouncements. FAS 14 and related pronouncements generally required public business enterprises to report segment information by industry and geographic area.

"Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision

maker in deciding how to allocate resources and in assessing performance." FAS 131, at 4. When Petitioner in its public financial statements filed with the SEC reported its investment in Lexis/Nexis as a "significant business segment," that reporting was required in accordance with FAS 14 and later FAS 131 to help users of Petitioner's financial statements. Petitioner's segment reporting did not evidence any operational connection between Lexis/Nexis and Petitioner in Illinois. Indeed, if it did, then every "public business enterprise" that disposes of a reportable business segment recognizes apportionable, business income regardless of whether the underlying relationships satisfy this Court's standards under the unitary business principle, thereby effectively defeating the purposes of the unitary business principle as a limitation on the taxing authority of a State. While Petitioner clearly cared about allocating resources and assessing the performance of Lexis/Nexis, "that state of mind sheds little light on the question whether in pursuing maximum profits they treated [the stock in Lexis/Nexis] as serving, on the one hand, an investment function, or, on the other, an operational function." *Allied-Signal,* 504 U.S. at 784-785.

Petitioner's segment reporting satisfied public financial reporting requirements and served investment functions for the owners and holders of the equity and debt issued by Petitioner.

III. SINCE 19 STATES SOLELY OR SIGNIFICANTLY RELY ON THIS COURT FOR THEIR DEFINITIONS OF APPORTIONABLE, "BUSINESS INCOME," THE IMPROPER AND EXPANSIVE INTERPRETATION OF OPERATIONAL FUNCTION BY THE ILLINOIS APPELLATE COURT IS AN IMPORTANT QUESTION OF FEDERAL LAW THAT SHOULD BE SETTLED BY THIS COURT.

A total of 46 States and the District of Columbia impose a tax on the net income of corporations. Although the number of States defining apportionable, "business income" under state law using the UNIFORM DIVISION OF INCOME FOR TAX PURPOSES ACT ("UDITPA") or similar statutes[3] may maintain a slim majority, the trend among the States since this Court's decision in *Allied-Signal* is to rely solely or significantly on this Court's decisions to be their state law definitions of apportionable, business income. Thus, a number of States that used to define "business income" as a matter of state law using UDITPA now define "apportionable" or "business" income solely as "all income that is apportionable under the United States Constitution," including Illinois for transactions occurring after July 30, 2004.[4] Another group of States have retained

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[3] Under UDITPA, "business income" is defined to mean "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." UDITPA § 1(a). Conversely, "nonbusiness income" means "all income other than business income," UDITPA § 1(e). 7A UNIFORM LAWS ANNOTATED 141 (2005).

[4] GA. CODE ANN. § 48-7-31(a); 35 ILL. COMP. STAT. 5/1501(a)(1); MINN. STAT. § 290.17, subd. 3 and subd. 6; N.C. GEN. STAT. § 105-130.4(a)(1); and WIS. STAT. § 71.25(5)(a).

some or all of the UDITPA definition while adding "operational income" or "operationally related income" as determined under the United States Constitution to their state law definitions.[5] Of the 19 States that have broadly defined apportionable, business income, the largest group does not distinguish between "business income" and "nonbusiness income" at all. Instead, these States have chosen to treat all income as apportionable while placing the burden of proof on taxpayers to prove that particular items of income cannot be subject to apportionment based on the United States Constitution.[6] Therefore, in a minimum of 19 States the Illinois Appellate Court's decision will be at least persuasive authority in settling questions of federal law.

In *Allied-Signal* the Court provided one illustration of a capital transaction that served an operational function – interest income from short term investments that became part of a taxpayer's working capital. 504 U.S. at 787-788. Similarly, the Court provided two illustrations of transactions that did not – (1) a long-term corporate strategy of acquisitions and dispositions, and (2) use of transaction proceeds to fund future acquisitions. 504 U.S. at 788-789. The types of common capital transactions relied upon by the Illinois Appellate Court range far beyond what the

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[5] ALA. CODE § 40-27-1.1; FL. STAT. § 220.03(r); IOWA CODE § 422.32.2; N.J. STAT. ANN. § 54:10A-6.1; and 72 PA. CONS. STAT. § 7401(3)2.(1)(a).

[6] CONN. GEN. STAT. § 12-218; ME. REV. STAT. ANN. tit. 36 § 5211; MD. CODE ANN. TAX-GEN. § 10-304; MASS. GEN. LAWS ch. 63, § 38; NEB. REV. STAT. § 77-2734.06; N.H. REV. STAT. ANN. § 77-A:1; R.I. GEN. LAWS §§ 44-11-11 and 44-11-14(a); VT. STAT. ANN. tit. 32, § 5811; and VA. CODE ANN. §§ 58.1-406, 58.1-407, and 58.1-408 (dividends are allocable; all other income is apportionable).

Court illustrated in *Allied-Signal*. As more States look only to the decisions of this Court to define the income, gains, and losses they will treat as apportionable for state tax purposes, a writ of certiorari to the Illinois Appellate Court should be issued so that this Court, not the Illinois Appellate Court, can provide the proper and definitive guidance on when a capital transaction serves an operational, as opposed to an investment, function.

CONCLUSION

For the foregoing reasons, Gannett Co., Inc. respectfully requests that Petitioner's Petition for Writ of Certiorari be granted.

Respectfully submitted,

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IN THE

Supreme Court of the United States

MEADWESTVACO CORPORATION,
Successor in Interest to THE MEAD CORPORATION,
Petitioner,

v.

ILLINOIS DEPARTMENT OF REVENUE, DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE, AND TREASURER OF THE STATE OF ILLINOIS,
Respondent.

On Petition for a Writ of Certiorari to the Illinois Appellate Court

BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* IN SUPPORT OF THE PETITIONER

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IN THE

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Respondent.

On Petition for a Writ of Certiorari to the Illinois Appellate Court

BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* IN SUPPORT OF THE PETITIONER

INTEREST OF *AMICUS CURIAE*

Pursuant to Rule 37 of the Rules of this Court, Tax Executives Institute, Inc. respectfully submits this brief as *amicus curiae* in support of the petition for a writ of certiorari.[1] Tax Executives Institute (hereinafter "TEI" or

[1] Pursuant to Rule 37.6, *amicus* Tax Executives Institute, Inc. states that no counsel for a party has written this brief in whole or in part and that no person or entity, other than *amicus*, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief. Both parties have consented to the filing of this *amicus* brief.

"the Institute") is a voluntary, non-profit association of corporate and other business executives, managers, and administrators who are responsible for the tax affairs of their employers. TEI was organized in 1944 under the laws of the State of New York and is exempt from taxation under section 501(c)(6) of the Internal Revenue Code of 1986 (26 U.S.C.). The Institute is dedicated to promoting the uniform and equitable enforcement of the tax laws, reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers, and vindicating the Commerce Clause and other constitutional rights of all business taxpayers.

TEI has more than 7,000 members who represent more than 3,000 of the leading corporations in the United States, Canada, Europe, and Asia. TEI's members represent a cross-section of the business community whose employers are, almost without exception, engaged in interstate commerce. Therefore, TEI's members have a keen interest in this case, which involves the constitutional limits on the States' ability to impose tax on a nondomiciliary taxpayer's income that bears no connection with the taxpayer's in-state activities.

The Due Process and Commerce Clauses require some definite link—or nexus—between the State and the activity to be taxed. Without such a connection, the state taxing scheme will be struck down as unconstitutional. Here, the State of Illinois impermissibly apportioned and hence imposed tax on the nonunitary, investment income of a multistate corporation—specifically, the gain realized by Petitioner MeadWestvaco Corporation upon the disposition of the assets of another company (Lexis/Nexis) that it held for investment purposes. In sustaining the State's action, the court below distended and effectively disregarded this Court's decision in *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992), which holds that when investment income is derived from activities unrelated to the business activities of a

unitary business, "due process considerations . . . preclude apportionability." *Id.* at 780.

The companies represented by the Institute's membership are directly and materially affected by the rules governing allocation and apportionment of income among the States. By ignoring the Court's teaching in *Allied-Signal*, the Appellate Court of Illinois denied MeadWestvaco the constitutional protections of the Commerce and Due Process Clauses. If permitted to stand, the decision will unsettle the expectations of all multijurisdictional companies, including those represented by TEI. Accordingly, TEI and its members will be directly affected by the disposition of this case.

SUMMARY OF ARGUMENT

In this case, the State of Illinois seeks to tax the gain realized by MeadWestvaco Corporation upon the disposition of another, nondomiciliary company (Lexis/Nexis) that it held for investment purposes. In sustaining the State's attempt, the Illinois Appellate Court distended and effectively disregarded the Court's seminal decision in *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992), which holds that a State may not tax the income of a nondomiciliary corporation if the income is derived from business activities that constitute a distinct business enterprise with business operations unrelated to the business carried on in the State. Thus, while the entire net income of a corporation generated by interstate as well as intrastate activities may be fairly apportioned among the States for tax purposes by formulas utilizing in-state aspects of interstate affairs, *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959), apportionment is not appropriate in the absence of a formal unitary business unless the asset or transaction in question serves an operational function rather than an investment function. *Allied-Signal*, 504 U.S. at 787.

That threshold is not satisfied here. The two businesses involved were completely separate and distinct. They did not share personnel or make purchases. They maintained separate headquarters, and they had no centralized operations or favorable intercompany transactions.

Under the Illinois court's analysis, investments in wholly owned businesses will, *ipso facto*, be treated as operational assets despite the lack of any unitary relationship between the subsidiary and the parent and without regard to why the company was acquired. Such a result, however, would eviscerate the Court's teaching in *Allied-Signal*, and thus, the petition for a writ of certiorari should be granted and the decision below reversed.

ARGUMENT

I. BACKGROUND

Petitioner, MeadWestvaco Corporation (hereinafter "Mead") is the successor in interest to Mead Corporation, an Ohio corporation, whose primary trade and business is producing and selling forest products, including paper, packaging and paperboard, and school and office supplies. Mead conducted business in several States, including Illinois. In 1968, Mead purchased Data Corporation, an Ohio-based company whose focus was developing ink jet printing technologies as well as the development of a computerized full text information retrieval system. The technology developed by Data Corporation evolved into a computerized full text information retrieval system that later became known as Lexis/Nexis.

After its acquisition of Data Corporation, Mead continued its business of manufacturing and selling paper and office products. Lexis/Nexis eventually became the world's premier provider of online legal information.

During the years it owned Lexis/Nexis, Mead treated the company as a business separate and distinct from its paper

products business. The two businesses did not share personnel or make joint purchases. They maintained separate headquarters and had no centralized operations. The two businesses had different corporate cultures and, in fact, were wholly independent of each other. Simply stated, Mead and Lexis/Nexis did not have a unitary relationship.[2]

In 1994, Mead sold Lexis/Nexis and reported the gain from the sale as nonbusiness income.[3] As nonbusiness income, the gain was not apportionable to (and hence not subject to income taxes) in Illinois and other states.

The Illinois Department of Revenue took issue with Mead's treatment of the gain, asserting that the gain should have been classified as apportionable business income subject to tax in Illinois. Mead challenged the Illinois's reclassification of the gain. The Cook County Circuit Court agreed with Mead that Lexis/Nexis was not part of its unitary business, but, nevertheless held that the gain from the sale of Lexis/Nexis was properly classified as apportionable business income because Mead's investment in Lexis/Nexis served an "operational" function. On appeal, the Illinois Appellate Court upheld the finding of the trial court. The Illinois Supreme Court declined to review this decision.

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[2] The Illinois Appellate Court did not review the lower court's decision regarding the lack of a unitary business finding. 371 Ill.App.3d 108, 117, 861 N.E.2d 1131, 1139 (2007).

[3] The transaction was structured as an asset sale.

II. THE ILLINOIS APPELLATE COURT MISAPPREHENDED THE COURT'S MANDATE IN *ALLIED-SIGNAL* WHEN IT PERMITTED ILLINOIS TO APPORTION MEAD'S GAIN FROM THE SALE OF A NON-UNITARY COMPANY HELD FOR INVESTMENT PURPOSES

This case presents the question of what connection, or nexus, must exist between a State and a nondomiciliary taxpayer's income from out-of-state sources or activities before that income can be apportioned to, and therefore taxed by, the State. In *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959), the Court confirmed that "the entire net income of a corporation, generated by interstate as well as intrastate activities may be fairly apportioned among the States for tax purposes by formulas utilizing in-state aspects of interstate affairs." *Id.* at 460.[4] The general permissibility of formulary apportionment, however, should not obscure or minimize the Constitution's limitation on the States' ability to tax out-of-state income.

To tax the out-of-state income of a nondomiciliary corporation, there must be a "minimal connection between the

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[4] Apportionment formulae are generally used to determine what part of a taxpayer's income may be properly taxed by the respective States. The purpose of any apportionment formula is to assign to the taxing State the amount of a taxpayer's total income that is earned in, and therefore is reasonably attributable to, the State. In apportioning the income of multistate unitary corporations, some States use the apportionment formula set forth in the Uniform Division of Income for Tax Purposes Act ("UDITPA") that requires a corporation to "separate its income into business income which is subject to apportionment among the various States, and nonbusiness income, which is allocated to a single State." Sanjay Gupta & Lillian Mills, *How Do Differences in State Corporate Income Tax Systems Affect Compliance Cost Burdens?* (2002). UDITPA divides income into business income, which is apportioned by means of a three-factor formula, and nonbusiness income, which is allocated according to the type of income and the type of property giving rise to the income.

interstate activities and the taxing State, and a rational relationship between the income attributed to the State and the intrastate values of the enterprise." *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 436-37 (1980) (quoting *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978)). A State may not tax the income of a nondomiciliary corporation—such as Mead here—if the income is derived from business activities that constitute a distinct business enterprise with business operations unrelated to the business carried on in the State. *See Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992). Indisputably, that is what Illinois is seeking to do here.

More than a century ago, this Court held that the taxability of a nondomiciliary taxpayer's out-of-state income turned on the application of the "unit rule" or the unitary business principle—on whether the out-of-state item sought to be taxed was "unitary" with, or functionally related to, the taxpayer's in-state activities. *State R.R. Tax Cases*, 92 U.S. 575, 608 (1875). In 1980, this Court encapsulized its prior holdings when it declared in *Mobil Oil Corp.* that the unitary business principle is the "linchpin of apportionability in the field of state income taxation." 445 U.S. at 439. Subsequently, *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982), and *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983), reaffirmed the unitary business principle and established standards for determining whether the requisite link exists between a nondomiciliary taxpayer's business activities within the State and its investments in or income from other entities.

In *Allied-Signal*, the Court explained that the "unitary business rule is a recognition of two imperatives: the States' wide authority to devise formulae for an accurate assessment of a corporation's intrastate value or income and the necessary limit on the States' authority to tax value or income that can-

not in fairness be attributed to the taxpayer's activities within the State." 504 U.S. at 780.

Under *Allied-Signal*, the Constitution permits the apportionment of income even in the absence of a formal unitary business where the asset (or transaction) in question serves an operational function rather than an investment function. 504 U.S. at 787. The Court explained that the inquiry whether an asset (or investment or transaction) serves an operational rather than investment function—

> focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing state. It is an inquiry to which our cases give content, and which is necessary if the limit of the Due Process and Commerce Clauses are to have substance in a modern economy.

Id. at 785.

Because the trial court found that there was not a unitary relationship between Mead and Lexis/Nexis, the proper disposition of this case turns on the application of the operational versus investment function test. Based on this test, *Allied Signal* requires reversal of the decision below.

The Appellate Court held that Mead failed its burden of proving "that Lexis/Nexis was not an operational asset," 371 Ill. App. 3d. at 117, 861 N.E.2d at 1139-40, but its analysis proves too much. In reaching this determination, the lower court said: "Mead was 100% owner of Lexis/Nexis. Although Mead did not have day-to-day control over Lexis/Nexis, its involvement with Lexis/Nexis was more than merely passive." *Id.* at 118, 861 N.E.2d at 1140. Thus, under the Illinois court's analysis, investments in all wholly owned companies will be treated as operational assets despite the lack of any unitary relationship between the company and the parent and without regard to why the company was acquired.

Requiring gains from the sale of wholly owned companies, *ipso facto*, to be apportioned without requiring more would distend if not eviscerate *Allied-Signal*. In that case, the State of New Jersey urged the Court to abandon the unitary business principle and allow nondomiciliary states to apportion (and tax) all of a corporation's income without regard to whether the income has a connection with the nondomiciliary state. *Allied-Signal*, 504 U.S. at 784. This Court rightly rejected this theory as sweeping, citing a 1982 discussion that held that the "*potential* to operate a company as part of a unitary business is not dispositive when, looking at 'the underlying economic realities of a unitary business' the dividend income from the subsidiaries . . . [was] derive[d] from 'unrelated business activity' which constitutes a 'discrete business enterprise.'" *Id.* at 784, citing *F.W. Woolworth Co. v. Taxation and Revenue Dep't of the State of New Mexico*, 458 U.S. 354, 362 (1982), (quoting *Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207, 223-224 (1980) (emphasis in original)). Likewise, the potential to integrate a wholly owned company into the parent's operations, without more, is not enough to justify classifying the ownership as "operational" in nature.

The Illinois Appellate Court also said that apportionment is defensible because Mead made contributions of capital and "manipulated" Lexis/Nexis's structure by changing its form from a division to a corporate subsidiary. 371 Ill. App.3d at 118, 861 N.E.2d at 1140. It failed to explain adequately, however, how these activities bolstered its conclusion. Increasing the amount of capital invested in a subsidiary may merely reflect an owner/investor's decision that the subsidiary presents a greater opportunity for return than other investment options. Likewise, transforming a wholly owned subsidiary into a division (or vice-versa) may reflect nothing more than a decision how to hold or own an investment (*e.g.*, as a pass-through entity for tax purposes or as a separate

taxpayer). Neither of these owner/investor decisions by itself reflect an operational purpose.

CONCLUSION

The Court should grant the Petition for a Writ of Certiorari to vivify its decision in *Allied-Signal* and reverse the Illinois Appellate Court's decision.

Respectfully submitted,

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July 18, 2007

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No. 06-1413

NOV 5 2007

In The
Supreme Court of the United States

MEADWESTVACO CORPORATION, successor in interest to THE MEAD CORPORATION,

Petitioner,

v.

ILLINOIS DEPARTMENT OF REVENUE, DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE, AND TREASURER OF THE STATE OF ILLINOIS,

Respondents.

On Writ Of Certiorari To The Appellate Court Of Illinois

JOINT APPENDIX

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Petition For Certiorari Filed April 20, 2007
Certiorari Granted September 25, 2007

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The following opinions, decisions, judgments, orders and other relevant parts of the record have been omitted in printing this joint appendix because they appear on the following pages in the appendix to the Petition for a Writ of Certiorari:

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Order of the Appellate Court of Illinois to Publish Rule 23 Order as a Precedential Decision 23a-24a

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Expert Opinion of Professor Richard D. Pomp 59a-77a

Expert Report of Ferdinand P. Schoettle, LL.D., Ph.D. 78a-103a

RELEVANT DOCKET ENTRIES

* * *

03/02/99	VERIFIED COMPLAINT FOR PRELIMINARY AND PERMANENT INJUNCTION AND FOR DECLARATORY RELIEF filed
03/02/99	MOTION FOR PRELIMINARY INJUNCTION filed
03/03/99	PRELIMINARY INJUNCTION ORDER filed
04/02/99	ANSWER filed
01/03/01	AGREED PRELIMINARY INJUNCTION ORDER entered
01/03/01	AGREED ORDER GRANTING LEAVE TO AMEND COMPLAINT entered
01/04/01	FIRST AMENDED VERIFIED COMPLAINT FOR PRELIMINARY AND PERMANENT INJUNCTION AND FOR DECLARATORY RELIEF filed
10/05/01	MOTION TO STRIKE filed
11/21/01	DEFENDANTS' BRIEF IN SUPPORT OF MOTION TO STRIKE filed
01/04/02	MEMORANDUM OF LAW IN OPPOSITION TO MOTION TO STRIKE filed
01/22/02	REPLY BRIEF IN SUPPORT OF MOTION TO STRIKE filed
03/18/02	PLAINTIFF'S WITNESS LIST filed

03/19/02	DEFENDANTS' WITNESS LIST filed
03/20/02	STIPULATION OF FACTS filed
03/20/02	TRIAL held
06/04/02	PLAINTIFF'S OPENING POST-TRIAL BRIEF filed
07/09/02	DEFENDANTS' POST TRIAL BRIEF filed
07/23/02	SUPPLEMENT TO DEFENDANTS' POST TRIAL BRIEF filed
09/13/02	PLAINTIFF'S REPLY BRIEF filed
03/18/03	MEMORANDUM DECISION, JUDGMENT AND ORDER of the Circuit Court of Cook County, Illinois in favor of the Defendants entered
03/25/03	FINAL JUDGMENT ORDER entered
04/11/03	NOTICE OF FILING (TRIAL TRANSCRIPT) filed
04/16/03	NOTICE OF APPEAL PURSUANT TO SUPREME COURT RULE 303 filed by Plaintiff
04/28/03	REQUEST TO PREPARE RECORD ON APPEAL filed
04/30/03	STIPULATION OF TRIAL EXHIBITS filed
11/03/06	RULE 23 (UNPUBLISHED) ORDER issued by the Appellate Court of Illinois affirming the judgment of the Circuit Court of Cook County, Illinois

11/14/06	MOTION TO PUBLISH RULE 23 ORDER AS A PRECEDENTIAL DECISION filed by the Illinois Department of Revenue
12/08/06	PETITION FOR LEAVE TO APPEAL filed by The Mead Corporation with the Supreme Court of Illinois
01/03/07	ORDER issued by the Appellate Court of Illinois granting the Illinois Department of Revenue's Motion to Publish Rule 23 Order as a Precedential Decision
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IN THE CIRCUIT COURT
OF COOK COUNTY, ILLINOIS
COUNTY DEPARTMENT, LAW DIVISION
TAX AND MISCELLANEOUS
REMEDIES SECTION

---------- x

THE MEAD CORPORATION,
an Ohio corporation,

Plaintiff,

v.

ILLINOIS DEPARTMENT OF REVENUE, GLEN L. BOWER, Director of Illinois Department of Revenue, and JUDY BAAR TOPINKA, Treasurer of the State of Illinois,

Defendants.

No. 00 CH 07854

Transferred to Law Division

STIPULATION OF FACTS

---------- x

STIPULATION OF FACTS

(Filed Mar. 20, 2002)

AND NOW, this 19th day of March, 2002, the parties, by their undersigned counsel, hereby stipulate and agree that the following facts are true and correct for purposes of this proceeding, that all exhibits referred to herein and attached hereto are incorporated into this Stipulation and made a part hereof, and that where such exhibits are not the

original documents referred to, they are true and correct copies thereof. The parties hereto reserve the right to introduce additional evidence, not inconsistent herewith, into the record at trial, and to object to the relevancy or materiality of any such additional evidence offered into the record, and of any facts set forth in the subsequent paragraphs of this Stipulation, or the exhibits to the Stipulation.

1. At all times relevant hereto, The Mead Corporation ("Mead") was and is a corporation incorporated under the laws of Ohio.

2. At all times relevant hereto, Mead was and is headquartered and maintains its commercial domicile at Courthouse Plaza Northeast, Dayton, Ohio 45463.

3. At all times relevant hereto, Mead was and continues to be qualified to transact business in the State of Illinois.

PROCEDURAL FACTS

4. Mead timely filed its Illinois Corporate Income and Replacement Tax Return ("Illinois Return") for the year 1994. Therein Mead (1) reported as nonbusiness income the gain of $1,056,001,948.00 from the sale of Mead Data Central, which consisted primarily of the business constituting the Lexis/Nexis service and therefore will be referred to as "Lexis/Nexis"; and (2) included in the denominator of its sales factor its gross receipts from the sale of financial instruments in the amount of $4,777,472,468.00. Mead

subsequently determined that the amount of its gross receipts from the sale of financial instruments was $4,846,382,229.00. This corrected amount is not in dispute. Also not in dispute is that of this total amount of gross receipts, $1,967,953.61, was interest income.

5. The Illinois Department of Revenue ("Department") conducted an audit of Mead's Illinois Returns for the years 1993 and 1994. On December 10, 1998, the Department issued a Notice of Deficiency for the years (1) 1993, proposing a statutory overassessment in the amount of <$30,463.00>; and (2) 1994, proposing a statutory deficiency in the amount of $3,149,222.00, with interest in the amount of $1,049,017.00, less specified overpayments in the amount of $34,917.00, for a net amount proposed as due of $4,163,322.00. The adjustments for 1993 are not contested and only included herein because it was included with 1994 in the Notice of Deficiency.

6. On February 3, 1999, Mead paid to the Department $4,163,322.00, representing a payment under protest. The amount of the payment equaled the amount set forth in the December 10, 1998, Notice of Deficiency.

7. On March 2, 1999, a Verified Complaint for Preliminary and Permanent Injunction and for Declaratory Relief was filed in the Circuit Court for the Seventh Judicial Circuit, Sangamon County, Illinois, and was served on Defendants in this matter. Mead brought this action pursuant to the State

Officers and Employees Money Disposition Act, 30 ILCS 230/1 *et seq.* ("Protest Monies Act").

8. On April 2, 1999, Defendants filed with the Circuit Court for the Seventh Judicial Circuit, Sangamon County, Illinois, their Answer to the Verified Complaint for Preliminary and Permanent Injunction and for Declaratory Relief.

9. On April 26, 1999, Mead filed with the Circuit Court for the Seventh Judicial Circuit, Sangamon County, Illinois, its Reply regarding the Verified Complaint for Preliminary and Permanent Injunction and for Declaratory Relief.

10. On May 8, 2000 an Agreed Order was filed with the Circuit Court for the Seventh Judicial Circuit, Sangamon County, Illinois, transferring venue to the Circuit Court of Cook County, Illinois.

11. On October 27, 2000, the Department issued a second Notice of Deficiency for 1994 proposing a statutory deficiency in the amount of $79,625.00, along with interest in the amount of $34,616.00, less amounts previously paid of $39,890.00, for a total amount proposed as due of $74,899.00, based on Federal changes not in dispute herein, but that would affect the calculation of the apportionment formula.

12. On December 15, 2000, Mead paid to the Department $74,899.00, representing a payment under protest. The amount of the payment equaled the amount set forth in the October 27, 2000, Notice of Deficiency.

13. Mead was allowed to amend its original Verified Complaint instanter, to incorporate the December 15, 2000, payment under protest. On January 4, 2001, Mead filed its First Amended Verified Complaint for Preliminary and Permanent Injunction and for Declaratory Relief ("Complaint") with the Circuit Court of Cook County, Illinois, incorporating the December 15, 2000, payment under protest. Mead brought this action pursuant to the Protest Monies Act.

AGREED ISSUES

14. The following issues were set forth in Mead's Complaint:

Issue 1–Whether Mead correctly included in the denominator of its sales factor its gross receipts from the sale of financial instruments in the amount of $4,846,382,229.00 on its Illinois Return for 1994.

Issue 2–Whether Mead correctly allocated the gain of $1,056,001,948.00 from the sale of Lexis/Nexis on its Illinois Return for 1994, and if not whether Defendants correctly apportioned such gain.

15. Issue 1 was decided in Mead's favor by this Honorable Court by its granting of Mead's Motion for Partial Summary Judgment.

16. Defendants filed a Motion for Reconsideration regarding Issue 1 on February 25, 2002. Mead filed its Response on March 13, 2002.

Defendants opted not to file a Reply. The matter is scheduled for argument on March 20, 2002.

DISAGREED FACTUAL ISSUES

17. Mead asserts as a fact that it was not involved in the electronic publishing business. The Defendants dispute that fact.

AGREED FACTS REGARDING ISSUE 2

18. Mead was, and is, in the business of producing and selling forest products, including paper, packaging and paperboard, and school and office supplies.

19. Data Corporation was acquired by Mead in 1968 for $6,000,000.00. Shortly thereafter a portion of the assets of Data Corporation was transferred to a separate entity known as Mead Data Central.

20. At that time, Mead Data Central consisted of a small legal database.

21. Mead Data Central pioneered the field of computer assisted research in the early 1970s with its Lexis service and subsequently with its Nexis service in the 1980s, and Mead Data Central's service became known to the outside world as Lexis/Nexis.

22. Lexis/Nexis grew from a small legal database into the world's premier provider of online legal information and the pioneer of computer-assisted news retrieval.

23. Lexis/Nexis provided online information services for legal, news and financial information in the electronic publishing market.

24. Lexis/Nexis marketed its services under the LEXIS/NEXIS brand name. To most outside parties, LEXIS/NEXIS was how the business was known.

25. Mead did not use the LEXIS/NEXIS brand name in its forest products business.

26. Lexis/Nexis was responsible for its own operational training programs.

27. Lexis/Nexis retained its own outside legal counsel appropriate for handling its unique legal matters.

28. Lexis/Nexis maintained its own internal legal department, separate and apart from Mead's legal department.

29. Lexis/Nexis' legal department was responsible for handling day-to-day operational issues including negotiating licenses, employee matters, and technology agreements.

30. Lexis/Nexis maintained its own financial staff, separate and apart from Mead's financial staff.

31. Lexis/Nexis maintained its own accounting department, separate and apart from Mead's accounting department.

32. Lexis/Nexis maintained its own internal audit department, separate and apart from Mead's internal audit department.

33. Lexis/Nexis maintained its own credit and collection department, separate and apart from Mead's credit and collection department.

34. There were no transfers or sales of accounts receivables between Lexis/Nexis and Mead.

35. Lexis/Nexis maintained its own human resources department, separate and apart from Mead's human resources department.

36. Lexis/Nexis provided benefits for its employees that were different from the benefits that Mead provided to its employees.

37. Lexis/Nexis maintained its own marketing department, separate and apart from Mead's marketing department.

38. Lexis/Nexis' marketing department was responsible for the marketing of the services that it sold.

39. Lexis/Nexis' employees determined the marketing strategies and advertising campaigns for Lexis/Nexis.

40. The computer system used by Lexis/Nexis to service its customers was different from the computer systems used by Mead in its forest products business.

41. Lexis/Nexis maintained its own bank accounts that were separate from the bank accounts maintained by Mead.

42. There was no centralized purchasing of merchandise between Lexis/Nexis and Mead. For example, Lexis/Nexis and Mead each purchased the raw materials needed for their respective businesses.

43. There was no centralized manufacturing of product by Lexis/Nexis and Mead.

44. There was no centralized warehousing of merchandise by Lexis/Nexis and Mead.

45. Lexis/Nexis did not share manufacturing facilities with Mead.

46. Lexis/Nexis maintained its own facilities that were separate from the facilities maintained by Mead.

47. Lexis/Nexis' employees were located at its own facilities.

48. Lexis/Nexis created and modified its database services at its own facilities.

49. Due to concerns over security and the proprietary nature of Lexis/Nexis' business, employees of Mead could not obtain access to Lexis/Nexis' facilities without special authorization.

50. Lexis/Nexis did not share selling facilities with Mead.

51. Lexis/Nexis did not share distribution facilities with Mead.

52. There was no regular exchange of personnel from Lexis/Nexis to Mead nor from Mead to Lexis/Nexis.

53. Mead's approval was not needed for the promotion of personnel within Lexis/Nexis except with regard to the most senior executives of Lexis/Nexis.

54. Neither Mead's board of directors, officers, nor its management had anything to do with the determination of individual salary increases and bonuses of Lexis/Nexis' personnel except at the highest levels.

55. Neither Mead's board of directors, officers, nor its management had anything to do with the hiring or firing of Lexis/Nexis' personnel except with regard to the most senior executives of Lexis/Nexis.

56. Lexis/Nexis had its own full-time management to control its day-to-day operations.

57. During 1988, Lexis/Nexis was a separate, wholly owned subsidiary of Mead known as Mead Data Central, Inc. Mead and Lexis/Nexis filed separate Illinois Returns for the tax year 1988. The Department audited Mead and asserted that Mead and Lexis/Nexis were unitary businesses. The parties agreed to settle the disputed audit findings and Mead filed Illinois combined unitary Corporation and Replacement Tax Returns from that point forward.

58. Between 1988 and 1993, on its combined unitary Illinois Corporate Income and Replacement Tax Returns, Mead reported the following amounts of income and business expense deductions:

	Mead	Lexis/Nexis
Income	$3,829,995,123.00	$818,805,160.00
Deductions	$4,474,254,764.00	$684,422,461.00

59. Lexis/Nexis merged into and became a division of Mead in 1980. Lexis/Nexis was reincorporated in 1985. In 1993, Lexis/Nexis again merged into and became a division of Mead. Tax savings were considered in both of these mergers.

60. On May 16, 1994, Mead announced its intention to sell Lexis/Nexis.

61. Mead retained Goldman, Sachs & Co. to assist it in the divestiture.

62. On December 2, 1994, Mead announced the completion of the sale of Lexis/Nexis to Reed Elsevier plc for approximately $1.5 billion.

63. The sale of Lexis/Nexis by Mead represented the complete disposition and liquidation by Mead of the Electronic Publishing business.

64. After the sale of Lexis/Nexis, Mead never went back into the electronic publishing market.

65. The proceeds from the sale of Lexis/Nexis were used for a stock repurchase program, to retire

debt and to pay taxes. Specifically, $349,664,065.00 was allocated to the stock repurchase program, $725,550,000.00 to the retirement of debt, $424,700,000.00 to pay taxes and $85,935.00 for other purposes.

66. Mead decided to repurchase shares of stock and pay off outstanding debt in order to maximize the value of its stock for its shareholders and to minimize its vulnerability to a corporate takeover.

67. In response to Defendants' First Written Interrogatories, in particular Interrogatory 13, Mead stated that it believed that the difference between Mead's working capital at the end of 1994 and its working capital at the end of 1993 is attributable to the sale of Lexis/Nexis. For purposes of the interrogatory, working capital was defined as current assets minus current liabilities.

68. Mead's board of directors reviewed and approved large capital expenditures by Lexis/Nexis, changes to Lexis/Nexis' legal structure and other large, nonrecurring transactions; including the 1980 merger, approving capital expenditures in the amounts of $1,650,000.00 (for computer center expansion) and $7,672,000.00 (for two central processing units and related equipment) in 1984, the 1993 merger, a capital expenditure of $9,100,000.00 (for computer capacity increase) in 1994, forming a committee to approve an agreement with Dow Jones in 1994 (to distribute financial information), and the

acquisition of Journal Graphics in 1994 for approximately $6,000,000.00.

EXHIBITS

69. Attached and numbered as Exhibits as indicated, are true and correct copies of the following documents:

Exhibit 1 - Illinois Corporate Income and Replacement Tax Return for the year 1994

Exhibit 2 - Notice of Deficiency dated December 10, 1998

Exhibit 3 - February 3, 1999 payment and enclosed correspondence

Exhibit 4 - Agreed Order dated May 8, 2000

Exhibit 5 - Notice of Deficiency dated October 27, 2000

Exhibit 6 - December 15, 2000 payment and enclosed correspondence

Exhibit 7 - May 16, 1994 Mead Press Release

Exhibit 8 - Two Articles from Tuesday, May 17, 1994, Dayton Daily News entitled "Exiting info highway, Mead to sell data unit, concentrate on forest products" (Summaries on right hand side

of page 1A), and "3,800 workers include 2,000 employed here"

Exhibit 9- Article from Tuesday, May 17, 1994, Dayton Daily News entitled "Mead plans future on paper"

Exhibit 10- Mead's Motion for Partial Summary Judgment and Memorandum in Support of its Motion

Exhibit 11- Defendants' Response and Cross Motion for Partial Summary Judgment

Exhibit 12- Mead's Reply Regarding its Motion for Partial Summary Judgment

Exhibit 13- Order granting Mead's Motion for Partial Summary Judgment

Exhibit 14- Qualifications of Professor Walter Hellerstein

Exhibit 15- Qualifications of Professor Richard D. Pomp

Exhibit 16- Qualifications of Dr. Ferdinand P. Schoettle

Exhibit 17- Qualifications of Mr. Kennion Yano

Exhibit 19- Illinois Corporate Income and Replacement Tax Returns for

the year 1988, together with Notice of Disposition.

Exhibit 20- 1988 IL-1120-X

Exhibit 21- Auditor's Comments

Exhibit 22- Illinois Corporate Income and Replacement Tax Return for the year 1993

Exhibit 23- 1993 Annual Report

Exhibit 24- 1994 Annual Report

Exhibit 25- 1993 Form 10-K

Exhibit 26- 1994 Form 10-K

Exhibit 27- Board of Directors minutes: 12/11/80, 7/26/84, 12/10/93, 2/24/94, 4/27/94, 4/28/94, 5/14/94, 8/4/94, 10/4/94, 10/29/94, 12/9/94 (as redacted by Mead)

Exhibit 28- Unanimous Written Consent of the Debt Committee, 12/3/94

Exhibit 29- Mead Corp. Gross Receipts 1994

Exhibit 30- Mead Corporation, report by Goldman, Sachs & Co., 10/21/94

Exhibit 31- Mead Corporation: Alternatives for Reinvestment of MDC Proceeds, report by Goldman, Sachs & Co., 9/8/94

Exhibit 32- Notices of Redemption to Bankers Trust Co. and Citibank, N.A., 12/6/94

Exhibit 33- Press Release, Mead Board Authorizes Program for Stock Buyback; Debt Reduction, 10/31/94

Exhibit 34- Press Release, Mead Corp. Board Calls Debentures for Redemption and Authorizes Repurchase of Notes, 12/7/94

Exhibit 35- Memorandum from L.J. Francis to T.E. Palmer, MDC's Proposed Merger Writeup, 11/17/93

Exhibit 36- Memorandum from Eve Kempfer to David A. Heuhardt, Mead Data Central/Mead Digital Systems merger, with attachments, 1/13/80

Exhibit 37- Recommendation to Board of Directors re: Liquidation/Merger of Mead Data Central Inc. and Mead Digital Systems Inc., 12/11/80

70. The parties agree that Professor Walter Hellerstein is qualified to testify as an expert in the field of tax policy. *See*, Exhibit 14.

71. The parties agree that Professor Richard D. Pomp is qualified to testify as an expert in the field of tax policy. *See*, Exhibit 15.

72. The parties agree that Dr. Ferdinand P. Schoettle is qualified to testify as an expert in the field of economics. *See*, Exhibit 16.

73. The parties agree that Mr. Kennion K. Yano is qualified to testify as an expert in the field of accounting. *See*, Exhibit 17.

Respectfully submitted,

/s/ Paul H. Frankel

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Attachments

[Some Exhibits Intentionally Omitted]

[EXHIBIT 2]

ILLINOIS DEPARTMENT OF REVENUE
101 West Jefferson Street
Springfield, Illinois 62794

December 10, 1998

FORM IL-1120

FEIN: XX-XXXXXXX

TAXABLE YEAR(S) ENDING:
12/31/93 and 12/31/94

STATUTORY DEFICIENCY:
$3,149,222.00

INTEREST TO DATE:
$1,049,017.00

LESS SPECIFIED OVERPAYMENTS:
$ 34,917.00

NET AMOUNT DUE:
$4,163,322.00

NOTICE OF DEFICIENCY

The Mead Corporation
C/O Mead Tax Department
Courthouse Plaza NE
Dayton, OH 45463

Pursuant to Section 904(c) of the Illinois Income Tax Act, notice is hereby given that the determination of your income tax liability for the above-noted taxable year(s) discloses a deficiency (or deficiencies) in the amount shown above. The attached statement contains explanations of the adjustments and shows the computation of the deficiency (or deficiencies).

IF YOU AGREE to this determination and pay the NET AMOUNT DUE shown above within thirty (30) days of the date of this notice, no additional interest will accrue. The payment should be forwarded to the address shown below.

IF YOU DO NOT AGREE, Section 908(a) of the Act provides that the Department shall reconsider the proposed assessment if within 60 days of the date of this notice, the taxpayer or his authorized representative files a written protest setting forth the grounds upon which the protest is based and, if requested, shall grant the taxpayer or his authorized representative a hearing (under Section 914). Thus, if you disagree with the assessment proposed, you may file a protest and, if desired, request a hearing. A protest, if filed, should be forwarded to the address shown below.

IF AN ADEQUATE AND TIMELY PROTEST is not received, the total amount of the deficiency shown will be deemed assessed as of the expiration of the aforementioned 60-day period pursuant to Section 903(a)(2) and 904(d). If no protest is filed and if the tax liability is not paid within 60 days of the date of this notice, a 15% penalty will be assessed under Section 3-3(b)(2) of the Uniform Penalty and Interest Act for liabilities which became due on or after January 1, 1994. If the tax remains unpaid after a demand for payment, the Act permits, in addition to other remedies, the seizure and sale of real and personal property to enforce collection.

Very truly yours,

/s/ Kenneth Zehnder
Director of Revenue

Enclosures: EAR-14, IDR-867
Return Envelope
Schedule of Interest Rates

NOTICE SECTION
ILLINOIS DEPARTMENT OF REVENUE
PO BOX 19012
SPRINGFIELD, IL 62794-9012
PHONE: 217-782-5835
ATTENTION: GDP (38017A)

STATEMENT

FEIN: XX-XXXXXXX
The Mead Corporation
Courthouse Plaza NE
Dayton, OH 45463

Pursuant to Section 909(e) of the Illinois Income Tax Act, notice is hereby given that your claim for refund of income tax overpayment in the amount of $8,726 for the taxable year ended 12/31/94, filed on 4/7/97, is denied in its entirety, while your claim for refund in the amount of $31,519 for the taxable year ended 12/31/93, filed on the same date, is partially denied. The Department holds the tax stated on the Notice of Deficiency to be the correct liability for these tax years and thus, finds no tax overpayment to exist.

IF YOU DO NOT AGREE, Section 910(a) of the Act provides that the Department shall reconsider the denial if within 60 days of the date of this notice, the claimant files a written protest thereto setting forth the grounds upon which the protest is based and, if

requested, shall grant the taxpayer or his authorized representative a hearing (under Section 914). Thus, if you disagree with the proposed denial of your claim, you may file a protest and, if desired, request a hearing. If an adequate and timely protest is not received, the denial of your claim in its entirety (or in the amount shown above) will become final as of the expiration of the aforementioned 60-day period pursuant to Section 909(f). A protest, if filed, should be forwarded to the address shown at the bottom of the cover letter.

EXPLANATION OF ADJUSTMENTS

Page 1

Taxpayer Name: The Mead Corporation

12/9/98

FEIN: 31-0535759

Audit Period: CYE 12/93, 12/94

Adjustments		12/31/93	12/31/94
We changed your capital gain due to the carryforward (or carryback) of a capital loss from another year. Ref: IITA Section 203(e)(2)(E).		-15,874,010	-6,997,201
We adjusted IL-1120, line 1 by including the federal taxable income of your FSC to reflect its status as a unitary group member. Ref: IITA Section 1501(a)(27).		1,080,215	1,137,779
We changed your subtraction modification for interest income from U.S. government obligations by disallowing obligations which are taxable. Ref: IITA Section 203(b)(2)(J).		-34,053	
We corrected your subtraction modification for interest income on U.S. Treasury obligations not previously claimed. Ref: IITA Section 203(b)(2)(J).			1,551,516
We adjusted your subtraction modification to reflect the foreign dividends allowed by Illinois law. Ref: IITA Section 203(b)(2)(O).		-84,793	-963,319
We changed to business income(loss) the amount of gain(loss) from the sale of property previously used in your trade or business operations. Ref: IAC Section 100.3010(d)(3).	Everywhere		-1,056,001,948
	Illinois		
We changed your deduction for non-unitary partnership income to include the income of partnerships that are unitary with your business operations. Ref: IAC Section 100.3380(c).	Everywhere	-22,955,842	-18,713,192
	Illinois		
The property factor was corrected to exclude intercompany rent expense between members of the unitary group. Ref: IAC Section 100.3320(d).	Everywhere	-2,336,992	-593,112
	Illinois		
We have corrected computational errors in the calculation of the property factor. Ref: IITA Sec. 304(a)(1)(A).	Everywhere	-6,914,116	-30,811,246
	Illinois	-3,219,273	-5,641,578
We adjusted everywhere payroll using your consolidated US-1120 which detailed the wage expenses incurred by each member of the combined group. Ref: IAC Section 100.3360.	Everywhere	2,397,107	2,238,461
We adjusted the Illinois sales to include receipts from intangible sales where the income-producing activity was performed in Illinois. Ref: IAC Section 100.3370(c)(3).	Everywhere		
	Illinois	3,919,563	

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We adjusted your sales factor to reflect gross sales less returns and allowances.	Everywhere		-301,153,465
Ref: IAC Section 100.3370(a)(1)(A).	Illinois		-18,041,307
We removed from the sales factor the amount of income excluded from Illinois base income.	Everywhere	-1,193,314	-6,658,475
Ref: IDOR policy.	Illinois		
The sales factor was corrected to include only the net gain from the sales of intangible assets.	Everywhere	-324,751,664	-3,639,057,064
Ref: IAC Section 100.3380(b)(6)	Illinois		42,126,702
We determined the amount of investment tax credit you were required to recapture based on property that ceased to be qualified property.	R		
Ref: IITA Section 201(e)(7).		1,149	1,486
We have adjusted your investment credit against the income tax by eliminating property that was not used in an Illinois enterprise zone.	Income Tax		-9,886
Ref: IITA Section 201(f).			
We have allowed an additional amount of investment tax credit that was available and previously unused. Ref: IITA Section 201(e).	Income Tax	10,931	
	Replacement Tax	12,010	84,231
We allowed an investment tax credit for property located in an Illinois enterprise zone that was not claimed on your original return.	I	40,871	
Ref: IITA Section 201(f).			

COMPUTATION FOR NOTICE OF DEFICIENCY Page 2

The Mead Corporation
Courthouse Plaza NE
Dayton, OH 45463

FEIN: 31-0535759
Tax yr begining: 1/1/94
Tx year ending: 12/31/94

FEDERAL TAXABLE INCOME			1,094,555,886
Exempt Interest Addition			2,298,309
IT and/or RT Addition			2,406,100
Other Additions:			0
US Gov't Interest Subtraction			1,551,516
Dividends (Sec 78, Sch J, Subpart F, Etc) Subtraction			11,982,938
Other Subtractions:			0
BASE/UNITARY BASE INCOME			1,085,725,841
Less: Nonbusiness Income			0
Partnership Income			-1,248,871
Apportionable Business Income			1,086,974,712
APPORTIONMENT	EVERYWHERE	ILLINOIS	FACTOR
Property Factor	5,159,190,015	103,285,415	0.020020
Payroll Factor	900,248,292	26,705,213	0.029664
Sales Factor	6,315,282,837	362,659,464	0.057426
Sales Factor	6,315,282,837	362,659,464	0.057426
Total Factors			0.164536
AVERAGE			0.041134
Illinois Business Income			44,711,618
Add: Illinois Nonbusiness Income			0
Illinois Partnership Income			0
Illinois NOL Carryback or Carryover			0
Illinois Base Income			44,711,618
Exemption and Illinois Net Income		41	44,711,577
Net Income and IT Tax @ 4%		44,711,577	1,788,463
Net Income and IT Tax @ .8%		44,711,577	357,693
Add: Investment Tax Cr Recapture			0
Less: IT Investment Cr			7,587
RT Tax Paid Cr			2,019
RT Tax Cr Carryforward			0
Net Income Tax			2,136,550
Illinois Base Income – RT			44,711,618
RT Addback		0	0
IL Base w/Adbk			44,711,618
Exemption and Net RT Income @ 2.5%		41	44,711,577
RT Tax @2.5 %			1,117,789
Net Income and RT Tax @ .35%		0	0
Add: ITC Recapture			1,486
Less: RT Investment Cr			97,877
Net RT Tax			1,021,398
Total Tax Per Audit			3,157,948
Less tax previously assessed			8,726
TAX DEFICIENCY			3,149,222
STATUTORY DEFICIENCY			3,149,222

Comments:

COMPUTATION FOR NOTICE OF DEFICIENCY — Page 1

The Mead Corporation
Courthouse Plaza NE
Dayton, OH 45463

FEIN: 31-0535759
Tax yr begining: 1/1/93
Tx year ending: 12/31/93

FEDERAL TAXABLE INCOME			43,099,981
Exempt Interest Addition			3,123,906
IT and/or RT Addition			1,898
Other Additions:			0
US Gov't Interest Subtraction			439,736
Dividends (Sec 78, Sch J, Subpart F, Etc) Subtraction			4,283,903
Other Subtractions:			0
BASE/UNITARY BASE INCOME			41,502,146
Less: Nonbusiness Income			0
Partnership Income			-1,304,033
Apportionable Business Income			42,806,179
APPORTIONMENT	EVERYWHERE	ILLINOIS	FACTOR
Property Factor	4,901,751,100	90,940,688	0.018553
Payroll Factor	904,879,238	23,079,723	0.025506
Sales Factor	5,088,150,528	330,707,573	0.064996
Sales Factor	5,088,150,528	330,707,573	0.064996
Total Factors			0.174051
AVERAGE			0.043513
Illinois Business Income			1,862,625
Add: Illinois Nonbusiness Income			0
Illinois Partnership Income			0
Illinois NOL Carryback or Carryover			0
Illinois Base Income			1,862,625
Exemption and Illinois Net Income		45	1,862,580
Net Income and IT Tax @ 4%		1,862,580	74,503
Net Income and IT Tax @ .8%		1,862,580	14,901
Add: Investment Tax Cr Recapture			0
Less: IT Investment Cr			51,802
RT Tax Paid Cr			0
RT Tax Cr Carryforward			0
Net Income Tax			37,602
Illinois Base Income – RT			1,862,625
RT Addback		0	0
IL Base w/Adbk			1,862,625
Exemption and Net RT Income @ 2.5%		45	1,862,580
RT Tax @ 2.5%			46,565
Net Income and RT Tax @ .35%		0	0
Add: ITC Recapture			1,149
Less: RT Investment Cr			47,714
Net RT Tax			0
Total Tax Per Audit			37,602
Less tax previously assessed			68,551
TAX OVERASSESSMENT			-30,949
MINUS: Section 1003 interest on restricted loss C/B credit			486
STATUTORY OVERASSESSMENT			-30,463

Comments:

SCHEDULE OF INTEREST RATES UNDER THE ILLINOIS TAX ACT

INTEREST RATE

For periods prior to 9/8/75	–	6% rate.
For periods from 9/8/75 thru 1/31/76	–	9% rate.
For periods from 2/1/76 thru 1/31/78	–	7% rate.
For periods from 2/1/78 thru 1/31/80	–	6% rate.
For periods from 2/1/80 thru 1/31/82	–	12% rate.
For periods from 2/1/82 thru 12/31/82	–	20% rate.
For periods from 1/1/83 thru 6/30/83	–	16% rate.
For periods from 7/1/83 thru 12/31/84	–	11% rate.
For periods from 1/1/85 thru 6/30/85	–	13% rate.
For periods from 7/1/85 thru 12/31/85	–	11% rate.
For periods from 1/1/86 thru 6/30/86	–	10% rate.
For periods from 7/1/86 thru 12/31/93	–	9% rate.
For periods from 1/1/94 thru 6/30/94	–	7% rate.
For periods from 7/1/94 thru 12/31/94	–	8% rate.
For periods from 1/1/95 thru 6/30/98	–	9% rate.
For periods from 7/1/98 thru 12/31/98	–	8% rate.
For periods from 1/1/99 and thereafter	–	7% rate.

[LOGO] **Illinois Department of Revenue**
Springfield IL 62794

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Please open immediately & read carefully.

CERTIFIED
Z 176 099 906
MAIL

[EXHIBIT 7]

Mead

Corporate Communications Department
World Headquarters
Courthouse Plaza Northeast
Dayton, Ohio 45463
513-495-6323

NEWS

FOR IMMEDIATE RELEASE

Contacts: Elizabeth L. Russo
The Mead Corporation
(513) 495-3312

Paul Verbinnen/
Kris Lawas
Sard Verbinnen & Co.
(212) 687-8080

MEAD TO FOCUS ON FOREST PRODUCTS BUSINESS; PLANS TO DIVEST MEAD DATA CENTRAL

DAYTON, OH, May 16, 1994—The Mead Corporation (NYSE: MEA) today announced that its Board of Directors has made a strategic decision to focus on growing Mead's core forest products business: paper, pulp, packaging and paperboard, containerboard and distribution and school & office products. Therefore, Mead plans to divest Mead Data Central (MDC), the leader in electronic information best known for its LEXIS/NEXIS® online services.

Goldman, Sachs & Co. has been retained to assist Mead in evaluating divestiture alternatives to maximize the value of MDC for Mead's shareowners. Mead believes a sale of MDC to a strategic buyer is

the most likely alternative, but other options will also be considered. The divestiture is expected to be completed this year.

"This is a time of tremendous opportunity for Mead in the forest products industry," said Steven C. Mason, Chairman and Chief Executive Officer of Mead. "We believe we can maximize shareowner value by devoting all of our resources to what we know best. We also believe this is the ideal time to unlock the value of the LEXIS/NEXIS® franchise for the benefit of our shareowners.

"The decision to divest MDC—a unique asset in a rapidly developing industry—is a difficult one. We have grown it since 1968 from a small legal database into the world's premier provider of online legal information and the pioneer in computer-assisted news retrieval. The LEXIS/NEXIS® names are two of the most recognized and valuable brand names in business today. MDC is performing well and, in this information age, has substantial growth ahead of it. However, we are convinced that its growth potential—as well as opportunities for its employees—can best be realized independent of Mead."

He added, "In a sale scenario, we would use after-tax proceeds to continue strengthening Mead's competitive position in our core business. We are evaluating several possible uses, including focused acquisitions, further productivity and quality improvements, debt reduction and a stock buy-back. Mead's Board and management are fully committed

to increasing shareowner value in the near- and long-term."

Mead's focus on productivity improvements and emphasis on high-end, value-added paper and packaging products has worked to increase profitability in a cyclical business. Noting that Mead's core business performed well relative to peers in 1993 and the first quarter of 1994—a difficult period for the industry—Mason said: "At the beginning of an up cycle in our business, we are well positioned for strong sales and improving profitability in the U.S. and overseas."

With offices and operations in 30 countries, Mead is one of the world's leading manufacturers of forest products. In 1993, Mead had net income of $124.1 million on revenues of $4.8 billion. In the first quarter of 1994, Mead had net income of $27.6 million on revenues of $1.2 billion, up 8% and 2% respectively over the previous year.

Mead's Business

Paper

- *Mead Publishing Paper* provides book and magazine publishers, catalog printers and commercial printers with more than 500,000 tons of medium-weight coated paper each year. The division has developed a full line of recycled book and glossy grades in response to customer interest.
- *Mead Fine Paper* produces both coated and uncoated paper for business, printing and

specialty uses. The division is also a leading producer of carbonless paper.

- *Mead Specialty Paper* manufactures saturating papers for use in decorative laminates used in commercial and home construction, remodeling and furniture. It also manufactures specialty grades for use in various industrial applications, including automobiles.

- *Gilbert Paper* produces high-quality communications papers, including cotton-content bonds, and specialty text and cover papers.

Packaging and Paperboard

- *Mead Packaging* is a leading supplier of multiple beverage packaging and packaging systems. It also provides multiple packages of food and other products. Customers include large and small brewers, soft drink bottlers, food and other consumer products companies.

- *Mead Coated Board* manufactures coated paperboard for use in multiple packaging and folding cartons. Customers include folding carton manufacturers in North America, Europe and Asia, in addition to Mead Packaging's worldwide business.

- *Mead Containerboard* produces corrugating medium used in shipping containers and operates eight corrugated container plants.

Distribution and School & Office Products

- *Zellerbach* distributes paper, packaging materials and machines, and industrial/commercial supplies in 65 local markets throughout the United States.
- *Mead School & Office Products* is the nation's largest manufacturer of school supplies. It also provides stationery products for home and office use, and is an industry leader in fashion and product design.

Wood & Pulp

- *Northwood Investees (50%-owned)*: Northwood Forest Industries Ltd. in Canada and Northwood Panelboard Company in the U.S. produce pulp, lumber and oriented structural board for a global market. Mead and Noranda Forest Inc., a leading Canadian forest products company, each have a 50% share in both companies. Northwood Forest Industries operates one of the world's largest bleached softwood kraft pulp mills, five saw mills, a plywood plant and wood treatment plant. It is a major supplier of northern softwood pulp to Mead's U.S. paper mills and Noranda's Canadian mills. Northwood Panelboard's oriented structural board plant in Bemidji, Minnesota is one of the lowest-cost producers in the country.
- *Wood Resources*: Mead owns or controls more than 1.3 million acres of timberlands in the United States. These lands supply approximately 16% of Mead's wood requirements.

Mead Data Central (to be divested)

Mead Data Central, which was acquired by Mead for $6 million in 1968, is the world's largest provider of online information services for legal, news and financial information and a major force in the electronic publishing market. Hundreds of thousands of people are active users of the company's online services, legal print and CD-ROM products, electronic publishing software, and productivity software. MDC's online databases contain millions of documents from over 4,000 news, business, financial and law-related sources.

MDC pioneered the field of computer-assisted research in the early 1970s with its LEXIS/NEXIS® service. It has maintained its leadership role in the industry through continual expansion of its databases into legal, news, financial and public records, as well as through strategic alliances and investments in new information management technologies.

As part of its strategy to expand and enhance information for customers and to integrate with customer environments, MDC has recently made targeted investments in key information-related technologies and applications. In 1988, The Michie Company was acquired to expand legal content and is now leading MDC's services in CD-ROM publishing. The 1989 acquisition of Jurisoft, a legal software provider, has helped dramatically improve users' productivity and quality in compiling and verifying legal research. In 1993, MDC purchased Folio

Corporation, a Utah-based pioneer in the development of PC and LAN-based electronic publishing software. Today, Folio's software is used by many companies to manage mission-critical internal information and by publishers to electronically publish on CD-ROM.

MDC is setting a new standard for efficiency and ease of use in database searching. Recent developments include an improved graphic interface, which takes full advantage of Microsoft's Windows™ technology, and MDC's innovative FREESTYLE™ feature, which allows users to search using plain English rather than traditional search commands.

In expanding the variety of services it offers, MDC has entered into strategic marketing and product joint ventures with providers of various PC-based technologies, including AT&T, WordPerfect Corp., Lotus Development Corp., American Lawyer Media, and General Magic. General Magic, a multimedia software company whose partners include AT&T, Matsushita, Apple, Sony, Motorola and Philips, is developing a personal information "appliance" for electronic communications and information retrieval. In addition, MDC and Disclosure Incorporated have just announced plans to offer jointly a series of products utilizing Securities & Exchange Commission filings, including data from its Electronic Data Gathering, Analysis and Retrieval (EDGAR) system.

[EXHIBIT 8]

Dayton Daily News

Volume 117
Number 249

Dayton, Ohio, Tuesday,
May 17, 1994

The First Cox
Newspaper

MeadDataCentral

Exiting info highway

Mead to sell data unit, concentrate on forest products

[Pictures And Caption Omitted In Printing]

Valley's high-tech image at stake

By Mike Casey
DAYTON DAILY NEWS

Mead Data Central's proposed sale adds uncertainty to the local economy and raises questions about the area's future as a high-tech center.

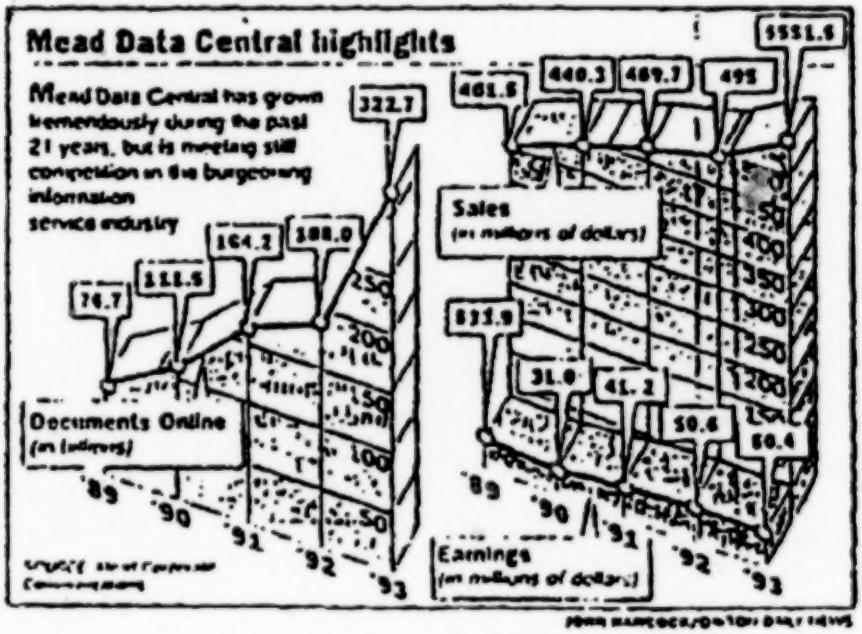
"The risk of it going is a real one," said John Weiler, director of the Center for Business and Economic Research at the University of Dayton.

Weiler said a purchaser in a similar field may decide to combine Mead Data's operations in another location. An information-service business is easy to move.

But Mead Data is important to the local economy. The Miami Twp. business employs 2,000 locally and Wright State University estimated the

company's local business generates another 1,500 to 2,000 area jobs.

What's more, it is a critical part of the area's future. Battelle, a Columbus think tank, said the Dayton economy has "high-growth potential" in information systems and software system design.



Battelle, hired by the Dayton Area Chamber of Commerce to study the area's economy, identified Mead Data as part of a 7,500-employee cluster of local institutions in those industries. Others are AT&T Global Information Solutions (formerly NCR), Reynolds and Reynolds Co. and Wright-Patterson Air Force Base.

Losing a premier institution could hurt efforts to attract other high-tech companies.

"We're trying to say, 'Dayton is a place to develop high-tech,'" Weiler said. "If we lose Mead Data Central . . . it says something negative about that concept."

The pending sale should not be counted as a loss, though.

Mead Corp. Chairman Steven Mason said a purchaser "will be intent on growing the business." The buyer may decide to expand the business in Dayton because of the existing buildings and personnel.

But he said Mead has not demanded that the buyer keep the business in the Dayton area.

Dayton has seen other home-grown businesses disappear.

In 1981, Carlson Marketing Group purchased locally based E.F. MacDonald, a travel and sales incentive company. Ten years later, Carlson transferred work to Minneapolis and Dayton lost 800 jobs.

"We know what can happen when you lose local control," said Jane Dockery, acting director of the Center for Urban and Public Affairs at Wright State.

Miami Twp. officials, however, said they weren't overly concerned, even though Mead Data Central paid $527,000 in property taxes last year to Miami Twp. and more than $1 million to the Miamisburg School District.

They said if the company relocates, the buyer will continue to owe property taxes. Township President Shirley Omietansky said the township also has the Dayton Mall, a major source of property tax revenue.

Mead Data employees didn't say much about the news. "They've told us not to talk to anyone about it. We're not supposed to talk to each other about it," said an employee who was eating at a nearby restaurant.

GETTING LESS HIGH TECH

- **Company:** Mead Corp.
- **Headquarters:** Courthouse Plaza Northeast, Dayton 45463
- **Chairman, CEO:** Steven C. Mason
- **Sales:** $4.8 billion (1993)
- **Net Income:** $124.1 million (1993)
- **Assets:** $4.2 billion
- **Employees:** 19,600
- **Telephone:** 495-3648
- **Fax:** 495-4088
- **Mead businesses:**

□ Mead Publishing Paper—coated papers for printing

□ Mead Fine Paper—business papers

□ Mead Specialty Paper—decorative papers

□ Gilbert Paper—high-quality communications papers

□ Mead Packaging—paperboard for beverage packages

- Mead Coated Board—paperboard for folding cartons
- Mead Containerboard—corrugated medium for boxes
- Zellerbach—paper distributor
- Mead School & Office Products—nation's largest supplier
- Northwood (50 percent owned)—produces pulp and lumber
- Wood Resources—1.3 million acres of timber land

■ **What happened:** Mead Corp. announced it will sell or spin off its high technology Mead Data Central division to focus on its core business, forest products.

■ **STAFF WRITERS** Timothy R. Gaffney and Jonathan Brinckman contributed to this story.

3,800 workers include 2,000 employed here

By Jim Bohman
and Jim Dillon
DAYTON DAILY NEWS

Mead Corp. announced Monday it will exit the increasingly hectic information superhighway and refocus on the quieter confines of its expanding forest products business.

The Dayton-based paper company, which pioneered computer data banks for lawyers and the

news media, said that it will either sell or spin off its profitable Mead Data Central unit by year's end.

"It's probably the toughest decision I've ever had to make," said Steven C. Mason, chairman and chief executive of Mead Corp. "You have two very good businesses, and you're trying to figure out how to maximize both of them."

Mason said he recommended the divestiture during a board meeting Saturday. Directors, he said, unanimously approved the move.

Mead Data's 3,800 employees learned of the decision Monday morning when they turned on their computers at company headquarters and at offices around the world. Electronic mail messages beckoned them to meetings about the sale.

"I don't think we're abandoning the (information) highway per se," Mason said. "We're saying the direction we're going to go will focus on 90 percent of our business."

No single event or decision triggered the move, Mason said. Instead, the decision was made after a long review of how Mead Corp. could best "maximize its value," Mason said.

"We've talked about this for a long time," Mason said of the proposed sale. He declined to be more specific.

Proceeds from the sale, which Mason declined to estimate, could be used for variety of purposes. The

money could be reinvested in the core business, used for a stock repurchase, paid out to shareholders as a special dividend, used to reduce debt or to make acquisitions. Mason, in a meeting with securities analysts Monday in New York, did not rule out considering purchase of a European paper mill.

Analysts estimated that Mead Data, with 2,000 local employees, could bring a price of about $1 billion. Possible buyers include companies in the publishing and telecommunications industries. AT&T is among those mentioned. Officials at the telecommunications giant declined comment.

"This is a time of tremendous opportunity for Mead in the forest products industry," Mason said. "We believe we can maximize share-owner value by devoting all of our resources to what we know best."

Acquired by Mead in 1968 for $6 million, Mead Data now is one of the world's largest providers of online information services.

"You have to understand that MDC is about 10 percent of our business, so it's a relatively small part of the company," Mason said.

In New York Stock Exchange trading Monday, Mead Corp. stock advanced 1¼ to close at 44 ½.

Kathryn McAuley, a forest products analyst with Brown Brothers Harriman in New York, said industry experts for years anticipated the sale of MDC because it was an odd appendage for a paper company.

McAuley said she gave Mead a "buy" rating in March, based in part on her speculation that the time might be ripe for the sale of Mead Data. But she said Monday she was stunned at how correct she was.

The profit potential for selling the division and making it into a separate, public company caught McAuley's attention. The analyst said MDC might bring a sale price of $1.1 billion.

McAuley estimates that MDC will contribute about 40 cents per share to the $2.75 per share she forecasts Mead will earn in 1994. Last year the company earned $2.08 per share.

Why exit a business of the future? "Maybe it's time for Mead Data Central to be partnered with somebody who has more synergistic contributions to make," McAuley said.

Anticipating the fast-moving future of telecommunications "no doubt is very different and very difficult for executives whose chief concerns are pulp and paper," the analyst said. "Mead Data Central needs to grow in a different fashion from paper."

Whoever buys Mead Data will acquire a veritable gold mine of potential products, said Barbara Quint, editor of Searcher magazine and an authority on information services. Quint said other "supermarket" type information services have caught up with Mead Data and become very competitive with it.

MEAD DATA CENTRAL

- **Headquarters:** 9393 Springboro Pike, Miami Twp.
- **President:** Rodney L. Everhart.
- **Sales:** $551.5 million (1993).
- **Profits:** $50.4 million (pre-tax).
- **Assets:** $459 million.
- **Employees:** 3,800 (2,000 Dayton area).
- **MDC business:** World's largest supplier of on-line legal, news and financial information.
- **Phone:** (513) 865-6800.
- **Fax:** (513) 865-7476.
- **Stock:** To follow trading in Mead Corp. shares, (MEA-NYSE) call the *Dayton Daily News* StockQuote Hotline on a Touch-Tone telephone. Call 463-4636, then enter 4000, then 1, then 61-32-21-*.

■ **What is Mead Data Central?** It is an electronic publisher of legal, business and financial news and information. Its Lexis and Nexis information retrieval services are used by professionals worldwide. 1993 sales were $551.3 million, up 11 percent from 1992. Page 5B.

■ **Why Mead Data Central being sold?** Steve Mason, Mead's chief executive officer, said Mead's objective is to "maximize shareholder value" and devote resources to the company's core forest products business.

■ **What does it mean for the Miami Valley?** Mead Data Central, which has 2,000 employees

locally, is a mainstay of the region's information and software systems industry, which includes AT&T, Reynolds & Reynolds, Standard Register and Wright-Patterson Air Force Base. Losing Mead would be a blow to this business cluster and the area economy.

■ **Who are the likely buyers?** Telecommunications concerns such as AT&T or regional telephone companies and electronic information companies such as West Publishing Co., which has a legal publishing arm.

■ **When will it be sold?** Mead hopes to complete the sale by year's end. Goldman, Sachs Co. of New York has been retained to find potential buyers. Page 5B.

■ **Mead stock:** To follow trading in Mead Corp. shares (MEA-NYSE), call the *Dayton Daily News* StockQuote Hotline on a TouchTone telephone. Call 463-4636, then enter Ext. 4000. Then key in 61 32 21.

■ **Speak up!:** Want to get something off your chest about the decision to sell Mead Data? If you have a TouchTone phone, please call 463-4636, then key in 1041. You'll have 45 seconds to make your point.

[EXHIBIT 9]

MeadDataCentral

'Now is the right time for Mead Corp. and the right time for MDC. It's the right time to maximize the value of both sides of this equation.'

Mead CEO Steven C. Mason

[Pictures And Captions Omitted In Printing]

Mead plans future on paper

By Jim Dillon
and Jim Bohman
DAYTON DAILY NEWS

For Mead Corp. directors, it is time to cash in the company's computer chips and concentrate on growing its core paper business, Mead Corp. Chairman and CEO Steven C. Mason said Monday.

For years, Mead Data Central dominated the electronic information market. In recent years, however, competitors such as Dialog, West Publishing and CD-ROM publishers have cut into that market share, stealing customers and introducing cheaper, more user-friendly ways of retrieving information.

Mead Corp., MDC's parent, apparently saw the handwriting on the wall last year and started re-evaluating Mead Data's performance and products.

Mead Data eventually laid off 400 employees, but hired more sales people and formed new alliances

with information providers, including *The New York Times* and American Lawyer Media.

More needs to be done, industry watchers said.

"Mead has always done a lot of fixing of its product, but they haven't done anything near what they must to reach a real mass market," said Barbara Quint, editor of *Searcher* magazine and an authority on information services. "Mead needs to add graphics, images and more natural language linkages, so people get answers, not just documents."

Still, Mead's decision to sell Mead Data Central comes as a surprise, said Mon Hatfield, editor of *News Library News*. "I would have thought this was one of their growth industries."

Mason said, "Now is the right time for Mead Corp. and the right time for MDC. It's the right time to maximize the value of both sides of this equation."

Mead Corp. pioneered the computer information and news retrieval service with NEXIS and LEXIS in 1973. Employment has grown to 3,800 worldwide, with 2,000 workers locally.

LEXIS is a data bank containing much of the world's law books, while NEXIS provides a computer database of articles from leading newspapers, magazines and other publications worldwide. Subscribers pay fees to search and use information from the data bases. Sales last year were $551.5 million.

MDC's pre-tax profit last year was $50.4 million, while total net profit of Mead Corp. was $124.1 million.

Potential buyers not lacking

By Mike Casey
DAYTON DAILY NEWS

Many companies in publishing and telecommunications will be interested in buying Mead Data Central, according to industry analysts.

"After all, it is the premier electronic publishing business," said Kathryn McAuley, a forest products analyst with Brown Brothers Harriman in New York. "I would feel that anyone who is in the field of electronics or in publishing would be likely buyers."

Any of the companies Mead has relationships with could be on the list, she said. They include AT&T, WordPerfect Corp., Lotus Development Co., General Magic, American Lawyer and Disclosure Inc.

She said AT&T might be a potential buyer "since Mead Data Central has several projects going with AT&T."

POSSIBLE BUYERS

■ **American Telephone & Telegraph Co. of New York:** Sales $67 billion. The world-wide communications giant is looking to get bigger. Company declined comment.

■ **Baby Bells:** The regional telephone companies want to participate in communications growth. Representatives for Ameritech, Bell Atlantic and Bell South declined comment.

■ **Time Warner of New York:** Sales of $6.5 billion. A major company in publishing information and entertainment. Spokesman not available.

■ **West Publishing Co. of Eagan, Minn.:** This direct Mead Data Central competitor does not release sales figures. Representatives said company "always looking for acquisition opportunities."

[EXHIBIT 21—Excerpts]

Auditor's Comments
The Mead Corporation

Nonbusiness Income

The taxpayer did consider gains and loss from the sales of intangibles as nonbusiness income. On January 1, 1994, Mead Data Central Inc. was merged into Mead Corp. They operated as a division of Mead prior to its sale on December 2, 1994. Mead also sold all of their subsidiaries whose business was associated with the electronic publishing business. It was determined all of the income should be classified as business income.

Since the taxpayer considered in the past all these companies to be unitary in their group, the income from the sale of these companies would be considered to be apportionable income. This meets the functional test in determining business income as discussed in The Kroger Company vs Department of Revenue court case. The taxpayer also disposed of other subsidiaries during the audit period and considered those transactions to be business income.

The dollars involved in the Mead Data Central and related companies was influencing the taxpayer's decision in classifying this transaction as nonbusiness.

See additional information that follows this report that includes ICU recommendation and TP position. There are also BOD meeting minutes.

Partnership Income

The taxpayer was associated with several partnerships. The Northwood Panelboard Company was a partnership that was considered to be unitary with this unitary group. There were 2 other partnerships, Cabin Bluff Partners and Cabin Bluff Management Co. that were in different lines of business and there was no centralized service functions. Those 2 partnership income/loss was allocated.

Factors

Property

Total combined property consisted of inventory, fixed depreciable assets, depletable assets and land, at cost, net of construction in progress and capital leases plus capitalized rent expense. To ensure consistency between everywhere and Illinois values, the components of the property factor were derived from sources which detailed values by state.

Payroll

Total combined payroll consisted of salaries and wages paid to all employees. The source of the payroll was the taxpayer's appointment workpapers. Illinois wages were calculated from the same source.

Sales

Total combined sales, per audit, consisted of gross receipts generated from all operations which produced business income. The include receipts, dividends, rents, royalties, interest, gains/loss from Schedule D, receipts from 4797 and other intangible income. The intangibles were included in the calculation since the taxpayer could identify the income producing activity and where that activity took place.

The Illinois sales, per audit, consisted of tangible sales destined for Illinois and Illinois services where the majority of the income producing activity was in Illinois. The taxpayer did not include service sales in other states that Illinois Code Inc. made to other states Illinois Code was not taxable. Those Illinois Code sales were considered Illinois.

An adjustment to the Illinois sales was made to include a portion of the tangible assets from the sales on Mead Data Central. Since the taxpayer could not identify the receipts by location, a percentage of Illinois to total MDC assets were applied to the receipts from the sale of tangible MDC assets.

Since all aspects of a business contributes to its goodwill, the Illinois property, payroll and sales percentage of MDC was used to calculate the portion of the gain of goodwill that would be attributable to Illinois.

Replacement Tax Investment Credit

The taxpayer claimed RT credit for both audit years but had not included proper support and Processing did not allow any of the credit. There was also allowable credit carryforwrd [sic] from prior years. This was verified from the prior Illinois audit.

Income Tax Investment Credit

The taxpayer claimed credits for their Chicago, IL. manufacturing plant. The prior Illinois auditor had called Illinois to verify the location was in the enterprise zone. All amounts claimed were allowed.

RT Investment Credit Recapture

There were assets claimed for their credit in 1993 by Illinois Code Inc. That company was sold during that year. Since the assets were not used 48 continuous months the credit was recaptured. Assets used by Mead Data Central that were claimed in 1993 and 1994 for the credit were also recaptured since Mead sold the company in December 1994.

Conclusion

The audit results were discussed with Ginger Bolser, state income tax compliance manager for Mead. The taxpayer has indicated from the beginning that would not agree with reclassifying the gain from the sale of MDC as business income. The auditor supplied a ICU application.

There was an ICU meeting with Mike Kinasz in October 20, 1997. It was determined we needed to read board of directors meeting minutes and the partnership agreement. This was done in January and copies were sent to Mike.

A letter from Mike follows this report.

If it is determined the gains are nonbusiness income. A portion of the gain should be allocated to Illinois. Schedule XI-b shows the calculation of the Illinois amounts that were included in the sales factor. This same schedule can be used to determine the amount of gain the belongs to Illinois if the gain is nonbusiness.

Unagreed Issues

See non-business section for unagreed issue and the conclusion section above.

The other issue was the taxpayer did not feel Northwood Panelboard partnership was not unitary with this group of companies. Copies of the partnership agreement are inclosed in the audit package. It supports that Mead Panelboard Inc. (partner) did exert management control over the partnership.

Audit Results

	Tax	Interest
12/31/93	–30,993	–9,438
12/31/94	3,149,195	820,393

Fred Murray 2/20/98

/s/ Fred Murray

[EXHIBIT 23—Excerpts]

[All Pictures And Captions Omitted]

The Mead Corporation
and Consolidated Subsidiaries
1993 Annual Report
to Shareowners

The Mead Corporation is one of the world's largest manufacturers of paper, producing more than 1.2 million tons annually for printing and business use; a long-established leader in coated paperboard and multiple packaging; a $1.6 billion distributor of paper packaging and business supplies made by manufacturers throughout the world; the largest maker of paper based school and home-office supplies; the developer of the world's leading electronic information retrieval services for law, patents, accounting, finance, news and business information.

Contents

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To Our Shareowners

NINETEEN NINETY-THREE was a year of progress for Mead. This was evident in our financial performance. Our most important achievements, however, are not yet so obvious. We've set higher expectations for ourselves in many areas, and generated significant learning around our three key success drivers. Results in these areas have set the foundation for future performance and will have a long-term impact on The Mead Corporation.

While our financial results improved compared to 1992 and placed us in the top quartile of our industry, we fell short of the expectations we established for ourselves at the beginning of the year. The economy around the world did not develop as we anticipated, corporate taxes increased, and many of our product lines suffered from over capacity. Especially hard hit were our pulp and uncoated paper grade lines. Prices were very competitive across the board, and we experienced real price declines in many areas. A notable exception was our wood products business, which enjoyed a very strong market throughout the year.

The change effort we began in 1991 is beginning to take hold. We made a commitment to you then that this effort and vision for the future would make a meaningful difference. It has. We began to measure our progress two years ago against the three key

initiatives we put in place at that time: customer satisfaction, productivity improvement and high performance management.

Total Customer Satisfaction. Independent outside surveys clearly show that the focused programs that are underway to better meet our customers' needs are working. Improved results are measured in an absolute and relative sense. For example, Mead Containerboard's medium system moved to a preferred position with customers, and we've made an outstanding leap forward in our NEXIS® information business. We are on the right track and are resolved to continue and redouble our efforts.

Total Productivity Improvement. Gains in productivity impact financial performance and often improve customer satisfaction. Our value-added productivity increased by 2.5% in 1993—about five times better than we've done in the past few years. Significant progress but still below our 3% goal. An outstanding example is our Escanaba mill, which nearly overcame a 10% price decline with productivity improvements. These achievements come from the combined efforts of many Mead employees who take pride in finding ways to work better and more efficiently.

High Performance Management. High performance management is harder to quantify. Our goals are to improve the way we select, grow and develop people; to provide a creative environment that fosters world-class performance; and to eliminate

barriers to meeting our customers' needs and Mead's financial objectives. Mead employees are rethinking and redefining key business processes that are vital for our future success. We've identified a lot of non-essential activity--we

* * *

1 Zellerbach's packaging unit provides customers with production line solutions and technical expertise. To hone that edge, sales and technical teams like Adam Meyer, Jr. and Jim Kronk shown here, are continually updated on the latest equipment and packaging solutions at the division training facility, making them more productive in front of customers—and helping customers become more productive long after the sales call ends.

2 Mead Data Central International opened a new processing facility in London during 1993, and added dozens of new international databases to the more than 250 already in the NEXIS® service. The facility brings MDCI closer to its international customers and to major newspapers, wire services and business publications outside North America. This means MDC can build new international databases faster, and more efficiently, with current information tailored to meet customer needs—wherever they are in the world.

* * *

1 Mead Containerboard and Mead Specialty Paper qualified for ISO 9000 status during 1993—the first Mead divisions to do so. High performing teams at both

divisions addressed the total manufacturing process and pinpointed specific improvements needed in order to meet the international quality management and assurance standards set by the International Standards Organization (ISO). International expansion offers important new opportunities for both divisions.

2 In response to customer requests for more ways to access the NEXIS®/LEXIS® databases, MDC introduced Easy-Search™, Table of Contents and FREESTYLE™ as alternatives to Boolean logic searching. FREESTYLE™, developed by a high performing team in record time, allows researchers to retrieve information using plain English inquiries.

3 Splicing together customer satisfaction with standard operating procedures, a high performing team from Publishing Paper responded to customer complaints by investigating accounting, quality control and production data then developing standardized procedures that would eliminate splice failures. By improving roll splices, Escanaba paper performs better on the printing press satisfying a crucial customer need. In front, left to right, Mead employees, Rod Deiter, Charlie Becker, (back row) Mike McDonald, Greg Kutha, Norm Boutilier, Kathy Krebs, and Sally Manning.

4 Consistently matching art directors' color specifications with the final printed product is a packaging challenge. A high performing team from Mead Packaging, Ink Products and Coated Board created standardized process colors and a new color

chart shown here that allows customers to see how specified colors will print on actual Mead coated board, which is used for packaging. What the art directors specify today is what they get on the shelf.

* * *

Review of Operations

The Mead Corporation and Consolidated Subsidiaries

Five-Year Data on Results of Operations

(All dollar amounts in millions, except per-share amounts)	YEAR ENDED DECEMBER 31				
	1993	1992	1991	1990	1989
Net sales	$ 4,790.3	$ 4,703.2	$ 4,579.3	$ 4,772.4	$ 4,608.2
Earnings from continuing operations	124.1	37.6	75.6	106.4	247.3
Net earnings	124.1	71.6	6.9	38.5	215.8
Per common share:					
Earnings from continuing operations	$ 2.08	$ .63	$ 1.29	$ 1.71	$ 3.80
Loss from discontinued operations			(.17)	(1.20)	(.47)
Extraordinary item				.11	
Cumulative effect of change in accounting principle		.58	(1.00)		
Net earnings	$ 2.08[1]	$ 1.21[2]	$ .12[3]	$ .62[4]	$ 3.33[5]
Effective tax rate on earnings from continuing operations	42.5%	43.1%	36.7%	35.6%	36.8%
Return on average total capital:*					
Earnings from continuing operations	6.3%	3.6%	5.3%	6.0%	11.8%
Net earnings	6.3%	4.8%	2.8%	3.5%	10.5%
Return on average equity:					
Earnings from continuing operations	8.1%	2.5%	5.0%	6.6%	15.5%
Net earnings	8.1%	4.8%	.5%	2.4%	13.5%

(1) Includes $7.6 ($.12 per share) charge related to the revaluation of deferred income taxes at January 1, 1993, resulting from 1993 income tax legislation

(2) Includes $17.7 ($.30 per share) loss from sale of Ampad and $58.9 ($1.00 per share) charge related to the comprehensive performance improvement program

(3) Includes $21.6 ($.37 per share) charge related to environmental matters and business consolidations, and a $26.4 ($.45 per share) gain from the sale of Micromedex, a medical information business

(4) Includes $56.2 ($.89 per share) charge related to the valuation of non-productive assets and costs of an early retirement program

(5) Includes $15.5 ($.23 per share) gain from sale of Mead Release Products

*Calculated by dividing net earnings plus interest and debt expense, net of taxes, by shareowners' equity plus long-term debt

Management's Discussion and Analysis

Overview of 1993

Despite negative market conditions facing most of its businesses, Mead's earnings improved over 1992 and 1991 levels. Driving the earnings increase were significantly improved results from Mead's Northwood affiliates; the large paper mills in Escanaba, Michigan, and Chillicothe, Ohio; and the Coated Board and School and Office Products divisions. Earnings from Mead's Containerboard, Packaging and Zellerbach divisions were lower than 1992 results.

Sales increased as a result of higher levels of sales volume in many businesses. Pricing pressures continued into 1993 for almost all operations resulting in lower average prices in 1993 than in 1992 and 1991. Pulp prices, which plunged in 1991, deteriorated even further in 1992 and 1993. The exception for pricing was Mead's affiliate, Northwood Forest Industries, where wood products' prices increased significantly in 1993 compared to 1992 and 1991, and provided the impetus for Northwood's earnings improvement.

Within Mead's paper operations, sales volumes were higher than 1992 and 1991 but average selling prices, continuing 1991's downward trend, were slightly lower, reflecting the lackluster economy and large increases to industry capacity in recent years.

Mead Coated Board's volume grew in 1993 as it did in 1992 and 1991. Mead Packaging's sales dropped from the 1992 level due in large measure to increased competitive pressures on pricing and weaker foreign market and currencies. The Containerboard Division was adversely affected by lower prices across its businesses, despite volume increases in the converting markets, and continued strong operations at the Stevenson, Alabama corrugated medium mill.

Market difficulties in the paper and industrial/ commercial supplies businesses continued to affect Zellerbach, Mead's nationwide network of paper merchant distributors. Improvements in productivity and cost reduction actions did not offset the effect of deteriorating prices.

Mead School and Office Products had another good year in 1993, with earnings higher than in both 1992 and 1991. The division liquidated the inventory purchased from Union Camp's school and office products business, contributing marginally to its favorable results.

Mead Data Central revenues grew 11% in 1993. However, strategic investments to enhance the features and functionality of its services, as well as expenditures for new product development and sales force restructuring, offset the effect of sales growth resulting in little earnings change from 1992.

Operating Results

Sales increased to $4.790 billion in 1993, compared to $4.703 billion in 1992 and $4.579 billion in 1991. The gains for both 1993 and 1992 were achieved despite the effects of lower paper prices and the sale of Ampad Corporation in July, 1992.

Earnings Per Share Analysis

	1993	1992	1991
Comparable earnings	$2.20	$1.93	$1.21
Other expenses		(1.00)	(.37)
Sale of business		(.30)	.45
Effect of tax rate change on deferred tax balance at beginning of year	(.12)		
Earnings from continuing operations	2.08	.63	1.29
Discontinued operations			(.17)
Cumulative effect of change in accounting principle		.58	(1.00)
Net earnings	$2.08	$1.21	$ .12

Comparable earnings were up almost 14% in 1993. However, the effect of the 1993 corporate tax rate increase of 1% on deferred taxes at January 1, 1993, negatively affected Mead's 1993 earnings from continuing operations by $.12 per share.

1992 comparable earnings were significantly improved over 1991 levels. The following items reduced 1992 earnings from continuing operations:

- A comprehensive performance improvement program resulted in an after tax charge of $58.9 million, or $1.00 per share.
- A $17.7 million after tax, or $.30 per share charge, represented a loss on the sale of the Ampad office products business.

In 1991, the $.37 per share charge related to costs for changing environmental requirements, business consolidations and the writeoff of certain engineering costs. The $.45 per share gain relates to the sale of Micromedex.

In 1992, Mead adopted Statement of Financial Accounting Standards (SFAS) No. 109, requiring the determination of all income tax liabilities at current rates. The effect of adopting the new standard was an increase in net earnings of $34 million, or $.58 a share. In 1991, earnings were negatively impacted by adjustments affecting Mead's discontinued reinsurance business, and adoption of SFAS No. 106 related to postretirement benefits.

In 1993, the company adopted SFAS No. 112, "Employers' Accounting for Postemployment Benefits." Adoption had no impact on the company.

Depreciation, amortization and depletion of property, plant and equipment amounted to $261 million in 1993, compared with $246 million in 1992 and $236 million in 1991.

Paper

Segment Summary

($ millions)	1993	1992	1991
Sales	$1,111.4	$1,090.6	$1,091.3
Comparable earnings	101.9	85.6	112.8
Other expenses		(22.3)	(20.7)
Earnings before income taxes	$ 101.9	$ 63.3	$ 92.1

Mead's paper segment earnings improved 19% on a comparable basis versus 1992, driven by strong operating results at the Chillicothe and Escanaba mills. Sales increased 2% in 1993 to $1.11 billion. Volume increased by about 11%, although prices across the board continued to be depressed. In 1992, sales were essentially flat compared with 1991, despite a 3% volume increase.

Industry capacity for coated paper in North America increased 8% during the last two years. Coated paper prices decreased slightly from 1992 throughout the industry. The American Forest and Paper Association (AF&PA) reports that total coated paper capacity will grow 3% in 1994 and 2% in 1995. As general economic conditions improve, demand is expected to outpace capacity growth, relieving some price pressures.

Mead Publishing Paper

The Publishing Paper division provides book and magazine publishers, catalog printers and commercial printers with more than 500,000 tons of medium-weight coated paper each year. The division has developed a full line of recycled book and glossy grades in response to customer interest.

Sales volume increased due to improved order volume. While pricing was flat for 1993 when compared to 1992, the division's earnings grew significantly as a result of reduced costs and improved operating efficiencies. In 1992, sales were approximately 9% lower than 1991, and earnings dropped considerably as well. In spite of some optimism about economic recovery, the publishing industry is predicting modest growth, at best, but not enough to absorb a continuing over-supply of paper.

To upgrade the product mix and improve quality, Mead is investing $115 million in two major capital projects that are expected to be completed in 1994 and 1995.

Mead Fine Paper

Mead Fine Paper produces both coated and uncoated papers for business, printing and specialty uses. The division is also a leading producer of carbonless paper.

Continued weak market conditions and depressed prices held sales growth to a modest increase for the

division's Chillicothe, Ohio, mill. However, improved productivity and good cost controls, due in part to capital investments and performance improvement efforts, resulted in significantly increased operating profit for the division. Additional savings and productivity increases are expected for 1994 as a result of continued cost reduction efforts and the effects of capital investment. Mead is investing $111 million to upgrade its coated sheet quality. Earnings growth is expected to be moderate in 1994 in light of the pricing conditions. Despite weak market conditions and depressed prices, 1992 sales were up 6% compared to 1991, while earnings were flat.

The Kingsport, Tennessee, mill continued to be hit hard by market conditions. The mill did not run as well as anticipated in 1993. Sales decreased slightly, and operating results fell significantly compared to 1992.

Mead Specialty Paper

Mead Specialty Paper manufactures saturating papers for use in decorative laminates used in commercial and home construction, remodeling and furniture; and specialty grades in various industrial applications including automobiles.

Sales for 1993 were up slightly from 1992 levels while earnings decreased. Excess global capacity and poor economic conditions in Europe limited growth in 1993. Cost reduction efforts could not offset operating inefficiencies associated with the start-up of a

capacity expansion project completed early in the year.

The U.S. housing, remodeling and auto production markets were stronger in 1993 than 1992 and these industries are forecasting a continuation of this trend. The division reported increased sales and earnings in 1992 compared to 1991.

Mead's Specialty division obtained ISO 9001 certification by meeting a set of international standards designed to improve product quality and consistency.

Gilbert Paper

The Gilbert Paper division produces high-quality communications papers, including cotton-content bonds, and specialty text and cover papers.

Gilbert reported slightly lower sales and earnings in 1993 due to reduced volume, a less profitable product mix, merchant consolidations and the weak economy. Productivity initiatives and performance improvement efforts should result in improved 1994 earnings. Sales of recycled grades and laser-compatible sheets continue to grow, as does potential for export growth.

The division reported a modest gain in 1992 sales compared to 1991, while earnings remained flat.

Packaging and Paperboard

Segment Summary

($ millions)	1993	1992	1991
Sales	$1,156.9	$1,163.2	$1,022.8
Comparable earnings	132.8	140.9	106.1
Other expenses		(23.8)	(1.6)
Earnings before income taxes	$ 132.8	$ 117.1	$ 104.5

Sales were essentially flat at $1.16 billion in 1993, and comparable earnings decreased 6%. Sales in 1992 rose 14% over 1991, while comparable earnings increased more than 32%.

A weak global economy and heightened competition leading to pricing pressures were key factors inhibiting growth in this segment. While cost improvements were significant across the divisions, they were not enough to combat difficult market conditions brought on by overcapacity.

Mead Packaging

Mead Packaging is a leading supplier of multiple beverage packaging and packaging systems. It also provides multiple packages of food and other products. Customers include large and small brewers, soft drink bottlers, food and other consumer products companies.

Lower brewery volume and lower than expected growth in the soft drink area, as well as price pressures, contributed to decreased sales and significantly reduced earnings for 1993 in North America. 1992 sales and earnings were flat compared with 1991.

International earnings were near 1992 levels. Exchange rates, weak European and Japanese economies, and increased pricing pressures were offset by good cost controls.

An ongoing series of cost-effective packaging systems solutions is expected to enhance the division's position with customers overall. To counter worldwide competition and continuing price pressures in the future, the division is intensifying ongoing cost reduction efforts and investing additional capital on productivity improvements for 1994.

Packaging opened subsidiaries in Mexico and Brazil in 1993 and increased its business in Australia. Groundwork has also been laid for new operations in Argentina, Chile and Poland for 1994, as well as other points around the globe.

Mead Coated Board

Mead Coated Board manufactures coated paperboard for use in multiple packaging and folding cartons. Customers include folding carton manufacturers in North America, Europe and Asia, in addition to Mead Packaging's worldwide business.

1993 was the third full year of operation for the expanded Mahrt mill in Alabama. Production increased more than 5% to exceed designed capacity of 800,000 tons. More significantly, production of first quality coated board increased by over 13% as operating efficiency and quality improved, and as sales increases eliminated the need to fill capacity with uncoated board. Despite weaker market conditions worldwide in 1993, sales volume increased 5% primarily due to the folding carton business worldwide. As a result of quality, cost and productivity initiatives, and more favorable results from the division's related wood products operations, earnings significantly improved. However, competitive pressures in the global board market have eroded prices for CNK® paperboard, Mead's coated natural kraft board. Sales rose 14% in 1992 and earnings rose compared to 1991.

The global market for coated paperboard is expected to grow modestly over the next few years. Mead Coated Board, however, expects its sales growth to be above the industry average as market development efforts of the past couple of years take hold.

Mead Containerboard

Mead's Containerboard division produces corrugating medium used in shipping containers and operates eight corrugated container plants.

Solid volume growth in the converting business and good cost controls at the medium mill could not

offset the effects of oversupply and price deterioration in both the medium and converted box markets. While sales were flat, earnings decreased compared to 1992. The division doubled its earnings in 1992 compared to 1991.

Independently conducted surveys in customer satisfaction showed the division's medium system has moved to preferred status with its customers. Its Stevenson, Alabama, mill obtained ISO 9002 certification.

Containerboard's inventory levels are stable and demand is on the upturn. It is expected that prices will solidify in 1994, and that additional productivity improvements will drive earnings improvement.

Distribution and School and Office Products

Segment Summary

($ millions)	1993	1992	1991
Sales	$1,970.7	$1,954.6	$1,995.7
Comparable earnings	38.4	45.6	36.3
Other expenses		(16.3)	(9.2)
Earnings before income taxes	$ 38.4	$ 29.3	$ 27.1

Sales increased to $1.97 billion for the Distribution and School and Office Products segment while comparable earnings were down 16% in 1993 versus 1992. Sales include those resulting from the liquidation of inventory purchased from Union Camp's school and office products division. Zellerbach's performance in a

poor market and costs associated with productivity improvements and restructuring were the reasons for decline in comparable earnings. 1992 sales were 2% below 1991 primarily as a result of the loss of revenue due to the sale of Ampad Corporation.

Zellerbach

Zellerbach distributes paper, packaging materials and machines, and industrial/commercial supplies in 65 local markets throughout the United States.

Continued price pressures offset the sales gains over 1992 for both the paper and industrial/ commercial supplies businesses. The packaging business continued positive trends in sales growth and margin percentage. Earnings for the division declined significantly in 1993 due to market pressures and the ongoing reengineering of the logistics system, including the consolidation of warehouses and the transition to selective use of third party providers of logistics services. Sales declined slightly in 1992 compared to 1991 but earnings were substantially improved.

Zellerbach accelerated strategic initiatives in 1993, including restructuring and reengineering projects that continue to improve customer satisfaction ratings, provide a competitive cost structure, and should positively impact performance in 1994. Zellerbach will continue to invest in its long-term growth in 1994.

School and Office Products

Mead's School and Office Products division is the nation's largest manufacturer of school supplies. It also provides stationery products for home and office use, and is an industry leader in fashion and product design.

The division's sales grew 6% in 1993 and 4% in 1992. This excludes sales related to the liquidation of inventory purchased from Union Camp's school supply business in 1993, and 1992 sales of Ampad, a business that was divested in 1992. The 1993 growth was primarily fueled by sales in the Five Star®, Five Star® First Geary™, and Cambridge® product lines.

Pre-tax earnings for School and Office Products increased over 1992 levels due to strong sales and operating performance; 1992 earnings were penalized by losses associated with the bankruptcy of a major customer.

In 1993, the division began to implement fully integrated production planning, inventory control, purchasing and accounts payable systems which are expected to reduce costs over the long term. Mead also entered into a licensing agreement with Nike, Inc., which should positively impact the 1994 back-to-school season.

Electronic Publishing

Segment Summary

($ millions)	1993	1992	1991
Sales	$551.3	$494.8	$469.5
Comparable earnings	50.4	50.6	41.2
Other expenses		(9.2)	(3.0)
Earnings before income taxes	$ 50.4	$ 41.4	$ 38.2

Mead Data Central (MDC) is a leading electronic publisher of legal, business, and financial news and information. Its LEXIS® and NEXIS® information retrieval services are used by professionals in a wide range of disciplines throughout the world.

MDC's sales increased by 11% to $551.3 million in 1993 compared to 1992. However, comparable earnings were essentially flat at $50.4 million, due in large part to strategic investments to enhance the features and functionality of its services, new product development, and costs associated with sales force restructuring. Competitive pressures remained intense, affecting pricing and costs in 1993.

In 1992, sales increased 9%, adjusted for the 1991 sale of a subsidiary. 1992 comparable earnings increased 23% from 1991.

MDC introduced a number of new products and product enhancements in 1993, most notably FREESTYLE™ which enables online users to search the databases using natural language rather than

Boolean logic. MDC also added a FINDER® library of current addresses, phone numbers and demographic data on 111 million individuals which helps attorneys locate heirs, witnesses and parties in legal actions. MDC's Folio business released version 3.0 of its electronic publishing software that enables users to create their own information bases for searching and retrieving internal information.

Sales from the business information services area led the way for MDC as it aggressively targeted new business while strengthening relationships with existing customers. The legal information area identified key customer segments and also expanded service to smaller firms.

MDC will continue to focus on market-driven product development and anticipates increased margins in 1994 due to an overall performance improvement effort conducted in 1993, and completion of the amortization of certain intangibles acquired in the purchase of The Michie Company in 1988.

Investees

Mead's primary investees are Northwood Forest Industries, Ltd., a large producer of bleached softwood kraft pulp and wood products in British Columbia, Canada, and Northwood Panelboard Company, an oriented structural board (OSB) mill at Bemidji, Minnesota. Both are 50%-owned by Mead and Noranda Forest Inc. of Canada. Pulp from

Northwood is sold throughout the world by Mead Pulp Sales. Wood products sales are handled by Noranda Forest Sales Inc.

Northwood's 1993 sales were up 12% from 1992. Mead's share of 1993 earnings of all investees was $18.4 million, up from $6 million in 1992. Mead's share of 1991 results was an $18.1 million loss.

Lumber prices were up substantially during the year, more than offsetting depressed pulp prices. Improved housing starts and increased repair and remodeling boosted demand, as did log supply curtailments, particularly in the Pacific Northwest. The industry expects more of the same in 1994, as the outlook is strong.

Pulp prices were weak in 1993. The average domestic price for 1993 was down 19% from 1992 and represents the third straight year of declining prices caused by over-supply, high inventories and sluggish paper markets, particularly overseas.

A gradual improvement in prices is expected for 1994, although full year average prices are expected to remain depressed.

Selling, Administrative and Research Expenses

Selling, administrative and research expenses rose by 2% in 1993, versus 6% in 1992. Administrative expenses decreased from 1992 levels as a result of Mead's performance improvement program. Selling and research expenses increased in

1992 and 1991 primarily due to MDC's accelerated sales and marketing programs.

Interest and Debt Expense

Interest and debt expense declined to $96 million in 1993 from $101 million in 1992 and from $114 million in 1991. The 1993 reduction reflected lower average interest rates, and the 1992 reduction resulted from both lower rates and a somewhat lower average level of debt.

* * *

R Industry Segments

The company operates in a number of industry segments. The *Paper* segment includes the manufacture and sale of printing, writing, carbonless copy, publishing and specialty paper and pulp. *The Packaging and Paperboard* segment includes the manufacture and marketing of beverage and food packaging materials, corrugated shipping containers and paperboard. The *Distribution and School and Office Products* segment includes the distribution of a full line of paper products and the manufacture and distribution of school and office products. The *Electronic Publishing* segment includes the electronic delivery of legal and news information services and the publishing of state statutes and other publications for the legal profession.

All dollar amounts in millions	Sales (1)					
Year ended December 31	1993		1992		1991	
	Unaffiliated	Inter-segment	Unaffiliated	Inter-segment	Unaffiliated	Inter-Segment
Industry segments:						
Paper	$1,111.4	$169.0	$1,090.6	$162.6	$1,091.3	$149.0
Packaging and Paperboard	1,156.9	9.2	1,163.2	8.3	1,022.8	7.3
Distribution and School and Office Products	1,970.7	9.1	1,954.6	10.0	1,995.7	5.5
Electronic Publishing	551.3	.2	494.8	.2	469.5	.2
Intersegment elimination		(187.5)		(181.1)		(162.0)
Total	$4,790.3		$4,703.2		$4,579.3	

All dollar amounts in millions	Other—Included in Determining Earnings (Loss) from Continuing Operations (2)		Earnings (Loss) from Continuing Operations Before Income Taxes (2)(3)(4)		
Year ended December 31	1992	1991	1993	1992	1991
Industry segments:					
Paper	$ 22.3	$20.7	$101.9	$ 63.3	$ 92.1
Packaging and Paperboard	23.8	1.6	132.8	117.1	104.5
Distribution and School and Office Products	16.3	9.2	38.4	29.3	27.1
Electronic Publishing	9.2	3.0	50.4	41.4	38.2
Corporate and other	45.9	(44.1)	(139.7)	(195.6)	(113.9)
Total	$117.5	$(9.6)	$183.8	$ 55.5	$148.0

All dollar amounts in millions	Identifiable Assets (5)			Capital Expenditures (Including Capital Leases)			Depreciation, Depletion and Amortization		
Year ended	1993	1992	1991	1993	1992	1991	1993	1992	1991
Industry segments:									
Paper	$1,345.7	$1,295.2	$1,274.3	$158.6	$ 92.2	$101.7	$ 94.2	$ 88.1	$ 85.9
Packaging and Paperboard	1,405.7	1,379.9	1,383.8	114.6	102.5	101.4	134.4	125.9	114.9
Distribution and School and Office Products	510.2	482.8	522.3	22.6	13.0	11.9	12.0	13.6	18.6
Electronic Publishing	459.1	460.8	475.4	40.6	52.6	43.1	62.4	57.8	54.9
Intersegment elimination	(17.8)	(17.2)	(16.1)						
Corporate and other	461.6	429.9	346.5	10.3	10.3	16.3	13.1	14.2	14.1
Total	$4,164.5	$4,031.4	$3,986.2	$346.7	$270.6	$274.4	$316.1	$299.6	$288.4

[See pages 85 and 86 for footnotes.]

(1) Intersegment sales are made at substantially the same prices and on the same terms as to unaffiliated customers.

(2) The earnings (loss) from continuing operations before income taxes includes other expenses related to the performance improvement program and a loss on the sale of a subsidiary in 1992; and environmental costs and costs of business consolidations and a gain on the sale of a subsidiary in 1991.

(3) Earnings from continuing operations before income taxes for "Corporate and other" includes the following:

Year ended	DECEMBER 31		
	1993	**1992**	**1991**
Other revenues:			
Gain (loss) on sale of subsidiary	$	$ (22.5)	$ 44.1
Other	3.7	7.6	5.2
Interest expense	(96.2)	(101.1)	(114.4)
Comprehensive performance improvement program		(23.4)	
Other expenses	(47.2)	(56.2)	(48.8)
	$(139.7)	$(195.6)	$(113.9)

(4) During 1993, in connection with the comprehensive performance improvement program, the company reorganized its corporate functions whereby certain expenditures are allocated to the operating units. Accordingly, earnings before income taxes for

1992 and 1991 have been increased (decreased) from amounts previously reported as follows:

Year ended	DECEMBER 31	
	1992	**1991**
Industry segments:		
Paper	$(1.7)	$(2.8)
Packaging and Paperboard	(8.9)	(9.6)
Distribution and School and Office Products	(5.1)	(4.7)
Electronic Publishing	(4.5)	(3.3)
Corporate and other	20.2	20.4
	$ 0.0	$ 0.0

(5) The assets of "Corporate and other" consist primarily of cash and cash equivalents, property, plant and equipment and investments in and advances to investees.

The cumulative effect of the change in accounting principle in 1991 is applicable to segments as follows:

Year ended December 31	**1991**
Industry segments:	
Paper	$30.2
Packaging and Paperboard	15.6
Distribution and School and Office Products	38.0
Electronic Publishing	2.8
Corporate and other	6.9
	$93.5

[EXHIBIT 24]

[Excerpts From Mead's 1994 Annual Report]

TO OUR SHAREOWNERS

NINETEEN NINETY-FOUR was a year of results and real progress. We began to feel the effects of stronger pricing in the fourth quarter of 1994, and I am pleased to report that our continuing improvement efforts and solid operating performance helped us to more than hold our own for the year as we continued to report improved earnings for 1994.

We significantly sharpened our focus on the core forest products businesses by the successful divestiture of our electronic publishing division (Mead Data Central) for $1.5 billion on December 2, 1994.

And we initiated several significant moves to increase shareowner value—a stock repurchase program, a major debt reduction program and sharply focused investments in our base businesses.

As a result of all the above, our balance sheet is the strongest it has been in recent history, giving us the financial capacity to invest in our core businesses. All in all a good year—but we still are not satisfied!

You may find it difficult to isolate truly comparative operating performance from our financial statements because of the special charges. These charges provide for key, known, upcoming events such as the anticipated sale of our Kingsport, Tennessee, paper mill. These charges are detailed in the financial footnotes. As I personally look at how

Mead actually performed in 1994 and set aside all the unusual items, the normalized earnings from operations are $2.90 per share. This contrasts with full-year reported earnings of $11.21, which also include the gain on the sale from Mead Data Central (MDC), and the effects of the other items.

OUR BALANCE SHEET IS THE STRONGEST IN RECENT HISTORY, GIVING US THE FINANCIAL CAPACITY TO INVEST IN OUR CORE BUSINESSES.

The divestiture of Mead Data Central was a difficult decision but clearly the right one for Mead at this time. The world of electronic information is rapidly changing. Some of the factors that helped Mead grow this business have been superseded by other factors in the electronic information industry. There was a lot of market interest in MDC and we certainly found a natural owner in Reed Elsevier. They have significant editorial expertise and wanted increased electronic market access. Reed particularly wanted to increase its presence in the U.S. legal information market.

STRATEGIC CHALLENGE. Our primary strategic challenge is to invest the MDC proceeds wisely. After extensive deliberation, your Board of Directors decided to allocate $350 million to a stock buy-back program, and an additional $400 to $600 million to reduce both short- and long-term debt. These

programs are in the process of being implemented—long-term debentures totaling $269 million have been [illegible] short-term

* * *

[EXHIBIT 25—EXCERPTS]

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 1994

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____
Commission File No. 1-2267

THE MEAD CORPORATION
(Exact name of registrant as specified in its charter)

Ohio	**xx-xxxxxxx**
(State of Incorporation)	**(I.R.S. Employer Identification No.)**

MEAD WORLD HEADQUARTERS
COURTHOUSE PLAZA NORTHEAST
DAYTON, OHIO 45463
(Address of principal executive offices)

Registrant's telephone number, including area code: 513-495-6323

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on which Registered
Common Shares Without Par Value and Common Share Purchase Rights	New York Stock Exchange Chicago Stock Exchange Pacific Stock Exchange
9% Debentures due 2017	New York Stock Exchange
6 3/4% Convertible Subordinated Debentures due 2012	New York Stock Exchange

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Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No _.

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K [ ]

As of January 27, 1994, the aggregate market value of the voting shares held by non-affiliates of the

Registrant was approximately $2,749,360,000 determined by multiplying the highest selling price of a Common Share on the New York Stock Exchange—Composite Transactions Tape on such date times the amount by which the total shares outstanding exceeded the shares beneficially owned by directors and executive officers of the Registrant. Such determination shall not, however, be deemed to be an admission that any person is an "affiliate" as defined in Rule 405 under the Securities Act of 1933.

The number of Common Shares outstanding at March 1, 1994 was 59,271,120.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of Registrant's Proxy Statement for the Annual Meeting of Shareholders scheduled to be held on April 28, 1994, are incorporated by reference in Part III; definitive copies of said Proxy Statement were filed with the Securities and Exchange Commission on March 14, 1994.

PART I

Item 1. Business

Mead manufactures and sells paper, pulp, paperboard, lumber and other wood products. Mead also manufactures and distributes school and office supplies, distributes paper and other industrial

supplies and is engaged in the electronic publishing business.

Mead was incorporated in 1930 under the laws of the state of Ohio as the outgrowth of a paper manufacturing business founded in 1846, and has its principal executive offices at Mead World Headquarters, Courthouse Plaza Northeast, Dayton, Ohio 45463, telephone (513) 495-6323. Except as otherwise indicated by the context, the terms "Company" or "Mead" as used herein refer to The Mead Corporation and its subsidiaries.

Segment Information

Segment information is also included in Note R on page 52.

Paper

Mead's Fine Paper division manufactures cut-size copier paper; uncoated and coated papers for commercial printing; form bond and carbonless paper and papers for conversion by others into business forms; and other uncoated papers for conversion by others into such products as greeting cards and bank checks. Mead's Publishing Paper division manufactures web coated offset paper for use by book, magazine, catalog and advertising brochure publishers. The Fine Paper division sells papers manufactured by both divisions nationwide, both on a direct basis to printers and converters and through

paper merchants, including merchants owned by Mead. Additionally, Escanaba Paper Company, a wholly-owned subsidiary, sells its output to the Publishing Paper division of Mead, which resells the paper directly to publishers and printers. The pulp mills adjacent to the paper mills of these divisions and the pulp mill owned by an affiliate (see "Forest Products Affiliates") produce virtually all of the pulp required for use in these paper mills.

The Company's Gilbert division manufactures cotton content and premium sulfite paper and premium recycled papers, including bond, banknote, texts and cover, and technical and specialty papers, and sells these products principally through paper merchants, including merchants owned by Mead.

Mead's Specialty Paper division manufactures and sells, primarily through its own sales force, decorative laminating papers. This division also manufactures absorbent, filter, fire resistant, synthetic fiber and other specialty papers. The division's principal customers include manufacturers that serve the building materials, automotive and furniture industries.

The Mead Pulp Sales division sells market pulp manufactured by Northwood Forest Industries Ltd. and by a non-affiliate, Aracruz Celulose S.A. The division maintains one sales office and is represented by affiliates and independent agents in all major pulp-consuming areas of the world. The principal

market areas for pulp are in North America, western Europe and Japan.

Packaging and Paperboard

The Mead Packaging division designs and produces multiple packaging and packaging systems primarily for the beverage take-home market. The division operates through a network of subsidiaries, affiliates and licensees in the United States, Canada, Europe, Japan, the Far East and Pacific Rim, Mexico and Latin America. Demand for most beverage packaging is seasonal with inventories being built from November to March for the peak soft drink and beer sales of April through October.

Mead Coated Board, Inc., a wholly-owned subsidiary of Mead, operates a coated paperboard mill near Phenix City, Alabama, and two sawmills in Cottonton, Alabama and Greenville, Georgia, and owns various timberlands in Alabama and Georgia. The subsidiary is engaged primarily in the manufacture of coated natural kraft products used by the beverage packaging industry and by manufacturers of folding cartons for soaps, food products, hardware and apparel. The entire output of the Phenix City mill is sold by Mead Coated Board, Inc. to the Mead Coated Board division. The division sells approximately 50% of the mill output to the Mead Packaging division. The remainder is sold to a wide range of domestic and foreign carton converters. The division's customers are most concerned about

physical strength properties of the paperboard and its quality for reprographics. Mead started up a new CNK® paperboard facility adjacent to the Phenix City mill in late 1990, and has constructed additional sheeting facilities in foreign countries to handle a portion of the increased capacity. In 1993, the division commenced operations at new facilities at the Phenix City mill designed to enable the division to meet beverage packaging customer demand for post-consumer recycled content.

The Mead Containerboard division sells standard and special purpose corrugated shipping containers manufactured at eight converting plants located in the Midwestern and Southeastern regions of the United States from raw materials received from outside sources and from the division's Stevenson, Alabama corrugating medium mill. The division also sells corrugating medium from the Stevenson mill to unaffiliated manufacturers of containers.

Forest Products Affiliates

Northwood Forest Industries Ltd. ("Northwood"), which is owned 50% by Mead and 50% by Noranda Forest Inc. ("Noranda"), manufactures bleached softwood kraft pulp at its 1,600 ton-per-day mill in Prince George, British Columbia. The principal markets for its pulp are in the midwestern United States, western Europe and Japan. Lumber and plywood products are also produced at Northwood's three sawmills and its plywood plant in British

Columbia. Northwood has the annual capacity to produce over one billion board feet of lumber and 175 million square feet of plywood (3/8-inch basis). Northwood's solid wood products' operations provide about 670,000 tons (ODT) of wood chips or 70% of the fiber requirements for the pulp mill. A wood preserving operation also treats lumber and custom treats plywood from other sources.

Northwood Panelboard Company, a partnership owned 50% by Mead and 50% by Noranda and located in Bemidji, Minnesota, has the annual capacity to produce approximately 340 million square feet of oriented structural board (3/8-inch basis).

All of the wood products produced by Northwood and Northwood Panelboard Company are sold through a subsidiary of Noranda primarily in North America with approximately 20% sold to export markets. Mead has a long-term contract with Northwood pursuant to which Mead is entitled to purchase such of Northwood's pulp production as it may require.

TIMBERLANDS

Mead obtains most of its wood requirements from private contractors or suppliers and from Company owned timberlands. The annual wood requirement for Mead's wholly-owned operations is approximately 8,000,000 tons, of which approximately 16% is obtained from timberlands owned or leased by Mead.

The approximate annual requirement of wood for Northwood is 5,800,000 tons, the majority of which is obtained from Crown Lands through various types of cutting rights which are terminable or renegotiable at the government's initiative and from third parties having similar cutting rights.

As of December 31, 1993, Mead owned or controlled approximately 1,337,000 acres of timberlands in the United States. Approximately 106,000 acres of land are controlled by Mead under long-term agreements which expire at different times through 2027.

Distribution and School and Office Products

Zellerbach, Mead's distribution operation, is a national distribution business which distributes a full line of printing papers, industrial supplies and packaging materials and equipment. These products are distributed through a network of wholesale locations and printer-supply retail outlets. The business units carry inventory or order products against sales orders, depending upon the product and service requirements. Zellerbach distributes not only products of Mead, but also those of several hundred other manufacturers. In the distribution of paper and other products, competing merchants frequently distribute products of the same supplier.

The Mead School and Office Products division manufactures and distributes a line of school supplies (including filler paper, wirebound notebooks,

portfolios and looseleaf binders) as well as a line of office supply products (including envelopes, filing supplies and vinyl folders and binders). The division's products are distributed primarily through mass market retailers, office supply superstores and warehouse clubs. The school supply segment is highly seasonal with inventories beginning to be built in the winter and spring for shipment in late spring and summer, while the home and office products portion of the business is generally less seasonal in nature. Manufacturing and distribution is done from seven United States plants/distribution centers, and a small manufacturing facility operated in Nuevo Laredo, Mexico.

Electronic Publishing

The Mead Data Central division ("MDC") markets electronic information services worldwide to corporations, financial institutions, news media, governments and the legal, medical and accounting professions. Based in Dayton, Ohio, MDC has sales offices in approximately 50 major U. S. cities, with international offices in London, Zurich and Toronto. Principal services include LEXIS®, a computer-assisted legal research service, and NEXIS®, a computer-assisted news, financial, marketing and general information retrieval service. MDC's services are distributed to subscribers via subscribers' own computer equipment and custom terminals supplied by MDC.

MDC operates several other businesses, including The Michie Company division, which publishes, reports and edits state statutes and other legal reference materials in book and CD-ROM format; LEXIS® Document Services division, which provides public records searching and retrieval services for law firms, financial institutions and other customers; and Folio Corporation and Jurisoft, software development companies. MDC also controls a minority interest in Star Data Systems, Inc., a Canadian company that provides real-time quote services to Canadian customers.

International Sales and Operations

Outside of the United States and Canada, Mead and its affiliates operate a paperboard sheeting facility and are engaged in the manufacture of multiple systems and folding carton packaging in Europe, Asia and Latin America. Mead also has sales subsidiaries, affiliates, agents or distributors in a number of countries in Europe, Asia, Australia and Latin America.

Competition

Mead competes on a world-wide basis in its product lines, and the markets in which Mead sells its products are highly competitive. Several factors affect Mead's competitive position, including quality, technology, product design, customer service, price and cost. The Fine Paper and Publishing Paper

divisions compete with numerous other major paper manufacturers. The Gilbert division competes with a number of other manufacturers of premium cotton, sulphite and recycled papers. The Coated Board division competes with other boxboard producers, including manufacturers of all types of coated recycled boxboard, coated solid bleach sulfate and folding boxboard. The Packaging division competes with a number of carton suppliers and machine manufacturers and one other global systems-based multiple packaging supplier. The Containerboard division competes primarily with container producers in several market areas. The Zellerbach division competes with national and regional merchant chains, as well as independent local merchants. The School and Office Products division competes with national and regional converters, some with broad product offerings and others focused on narrow product segments. MDC faces increasing competition for new products and markets from numerous on-line and CD-ROM information providers as well as book publishers.

Employee and Labor Relations

Mead employs approximately 19,600 persons, of whom approximately 7,700 are production, maintenance and clerical employees represented by labor unions. Mead's 50% owned company, Northwood, employs approximately 2,300 persons. Mead and Northwood have approximately 50 labor

agreements currently in force of which approximately one-third are subject to renegotiation each year.

Mead's employee relation policies are based on mutual confidence and trust. All Mead labor contract negotiations during 1993 were concluded without any strikes.

Trademarks, Trade Names, Patents, and Franchises

Mead has a large number of trademarks and trade names under which it conducts its business, including "Mead," "Mead Papers," "Mead Packaging," "Zellerbach," "Montag," "LEXIS," "Lexpat," "NEXIS," "Super Shades," "Trans/Rite," "Trans/Tab," "Cluster-Pak," "Cambridge," "Chief," "Apex," "Info," "Moistrite," "Trapper," "Trapper Keeper," "Neatbook," "Gilbert," "OPAS," "Signature," "CNK," "Five Star," "First Gear," "Neu-Tech," "Gilcrest," "Esse," "ORGANIZER," "Spiral," "Sig-NATURE," "Management Series," "NO! RULES" and many others. Mead also has a great number and variety of patents, patent rights, licenses and franchises relating to its business. While, in the aggregate, the foregoing are of material importance to Mead's business, the loss of any one or any related group of such intellectual property rights would not have a material adverse effect on the business of Mead.

Environmental Laws and Regulations

Mead's operations are subject to extensive regulation by various federal, state, provincial and local environmental control statutes and regulations. These regulations impose effluent and emission limitations, waste disposal and other requirements upon the operations of Mead, and require Mead to obtain and operate in compliance with the conditions of permits and similar authorizations from the appropriate governmental authorities. Mead has obtained, has applications pending, or is making application for such permits and authorizations. Mead does not anticipate that compliance with such statutes and regulations will have a material adverse effect on its competitive position since its competition is subject to the same statutes and regulations to a relatively similar degree.

During the past five years (January 1, 1989—December 31, 1993), Mead (including its share of Northwood expenditures) constructed air and water pollution control and other environmental facilities at a cost of approximately $115 million. Significant environmental expenditures in the future are anticipated to include long-term projects for the construction of solid waste disposal facilities, and maintenance and upgrade of wastewater treatment plants and air emission controls. Due to changes in environmental laws and regulations, the application of such laws and regulations and changes in environmental control technology, it is not possible for

Mead to predict with certainty the amount of capital expenditures to be incurred for environmental

* * *

	manufacturing location in Nuevo Laredo, Mexico	
Zellerbach	45 wholesale locations throughout the United States; one converting operation; 34 printer-supply retail outlets; and 3 third party warehouses	Paper, packaging equipment and supplies distribution facilities
Mead Data Central	Dayton Ohio	Headquarters and database location
	Springfield, Illinois	Headquarters of LEXIS® Document Services
	Charlottesville, Virginia	Headquarters of The Michie Company division
	Provo, Utah	Headquarters of Folio Corporation
	Cambridge, Massachusetts	Headquarters of Jurisoft

Item 3. Legal Proceedings

In March 1989, the Ohio Attorney General filed a lawsuit against Mead alleging violations of state solid waste and water pollution laws at two landfills (the

Paint Street Site and the Storage Depot Site) owned and operated by Mead Fine Paper Division's Chillicothe, Ohio mill. The lawsuit sought injunctive relief (orders closing one landfill and modifying operations at the other landfill) and civil penalties. Mead has denied the allegations in the complaint, and since the filing of the suit, Mead has ceased use of and proceeded to close both landfills. Mead is currently disposing of its solid wastes at alternate permitted facilities and using its paper mill sludge to reclaim strip mines. Mead believes that it has closed both landfills to the satisfaction of the Ohio EPA, although certain issues concerning groundwater monitoring and treatment, as well as civil penalties, remain to be resolved. While Mead cannot predict the outcome of this litigation, because the estimate of closure costs have already been accrued, Mead does not believe that the litigation will have a material adverse impact upon its financial condition or results of operations.

In a related matter, in September 1993 Mead signed a Consent Order with USEPA under Section 3008(h) of the Resource Conservation and Recovery Act with respect to the Storage Depot Site. Pursuant to the terms of that Order, Mead will undertake certain investigative and remedial work designed to control releases of hazardous substances from the site. Work has begun and is expected to continue into 1995.

Mead believes that the U.S. Navy is legally responsible for the groundwater contamination at the Storage Depot site, including the cost of

implementing the Consent Order discussed above. In 1992, Mead filed a declaratory judgment action

* * *

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

REVIEW OF OPERATIONS

OVERVIEW OF 1993

Despite negative market conditions facing most of its businesses, Mead's earnings improved over 1992 and 1991 levels. Driving the earnings increase were significantly improved results from Mead's Northwood affiliates; the large paper mills in Escanaba, Michigan, and Chillicothe, Ohio; and the Coated Board and School and Office Products divisions. Earnings from Mead's Containerboard, Packaging and Zellerbach divisions were lower than 1992 results.

Sales increased as a result of higher levels of sales volume in many businesses. Pricing pressures continued into 1993 for almost all operations resulting in lower average prices in 1993 than in 1992 and 1991. Pulp prices, which plunged in 1991, deteriorated even further in 1992 and 1993. The exception for pricing was Mead's affiliate, Northwood Forest Industries, where wood products' prices increased significantly in 1993 compared to 1992 and 1991, and provided the impetus for Northwood's earnings improvement.

Within Mead's paper operations, sales volumes were higher than 1992 and 1991 but average selling prices, continuing 1991's downward trend, were slightly lower, reflecting the lackluster economy and large increases to industry capacity in recent years.

Mead Coated Board's volume grew in 1993 as it did in 1992 and 1991. Mead Packaging's sales dropped from the 1992 level due in large measure to increased competitive pressures on pricing and weaker foreign markets and currencies. The Containerboard Division was adversely affected by lower prices across its businesses, despite volume increases in the converting markets, and continued strong operations at the Stevenson, Alabama, corrugated medium mill.

Market difficulties in the paper and industrial/commercial supplies businesses continued to affect Zellerbach, Mead's nationwide network of paper merchant distributors. Improvements in productivity and cost reduction actions did not offset the effect of deteriorating prices.

Mead School and Office Products had another good year in 1993, with earnings higher than in both 1992 and 1991. The division liquidated the inventory purchased from Union Camp's school and office products business, contributing marginally to its favorable results.

Mead Data Central revenues grew 11% in 1993. However, strategic investments to enhance the

features and functionality of its services, as well as expenditures for new product development and sales force restructuring, offset the effect of sales growth resulting in little earnings change from 1992.

OPERATING RESULTS

Sales increased to $4.790 billion in 1993, compared to $4.703 billion in 1992 and $4.579 billion in 1991. The gains for both 1993 and 1992 were achieved despite the effects of lower paper prices and the sale of Ampad Corporation in July, 1992.

Earnings Per Share Analysis

	1993	1992	1991
Comparable earnings	$2.20	$1.93	$1.21
Other expenses		(1.00)	(.37)
Sale of business		(.30)	.45
Effect of tax rate change on deferred tax balance at beginning of year	(.12)		
Earnings from continuing operations	2.08	.63	1.29
Discontinued operations			(.17)
Cumulative effect of change in accounting principle		.58	(1.00)
Net earnings	$2.08	$1.21	$ .12

Comparable earnings were up almost 14% in 1993. However, the effect of the 1993 corporate tax rate increase of 1% on deferred taxes at January 1,

1993, negatively affected Mead's 1993 earnings from continuing operations by $.12 per share.

1992 comparable earnings were significantly improved over 1991 levels. The following items reduced 1992 earnings from continuing operations:

— A comprehensive performance improvement program resulted in an after tax charge of $58.9 million, or $1.00 per share.

— A $17.7 million after tax, or $.30 per share charge, represented a loss on the sale of the Ampad office products business.

In 1991, the $.37 per share charge related to costs for changing environmental requirements, business consolidations and the writeoff of certain engineering costs. The $.45 per share gain relates to sale of Micromedex.

In 1992, Mead adopted Statement of Financial Accounting Standards (SFAS) No. 109, requiring the determination of all income tax liabilities at current rates. The effect of adopting the new standard was an increase in net earnings of $34 million, or $.58 a share. In 1991, earnings were negatively impacted by adjustments affecting Mead's discontinued reinsurance business, and adoption of SFAS No. 106 related to postretirement benefits.

In 1993, the company adopted SFAS No. 112, "Employers' Accounting for Post-employment Benefits." Adoption had no impact on the company.

Depreciation, amortization and depletion of property, plant and equipment amounted to $261 million in 1993, compared with $246 million in 1992 and $236 million in 1991.

PAPER

Segment Summary ($ millions)	1993	1992	1991
Sales	$1,111.4	$1,090.6	$1,091.3
Comparable earnings	101.9	85.6	112.8
Other expenses		(22.3)	(20.7)
Earnings before income taxes	$ 101.9	$ 63.3	$ 92.1

Mead's paper segment earnings improved 19% on a comparable basis versus 1992, driven by strong operating results at the Chillicothe and Escanaba mills. Sales increased 2% in 1993 to $1.11 billion. Volume increased by about 11%, although prices across the board continued to be depressed. In 1992, sales were essentially flat compared with 1991, despite a 3% volume increase.

Industry capacity for coated paper in North America increased 8% during the last two years. Coated paper prices decreased slightly from 1992 throughout the industry. The American Forest and Paper Association (AF&PA) reports that total coated paper capacity will grow 3% in 1994 and 2% in 1995. As general economic conditions improve, demand is

expected to outpace capacity growth, relieving some price pressures.

Mead Publishing Paper

The Publishing Paper division provides book and magazine publishers, catalog printers and commercial printers with more than 500,000 tons of medium-weight coated paper each year. The division has developed a full line of recycled book and glossy grades in response to customer interest.

Sales volume increased due to improved order volume. While pricing was flat for 1993 when compared to 1992, the division's earnings grew significantly as a result of reduced costs and improved operating efficiencies. In 1992, sales were approximately 9% lower than 1991, and earnings dropped considerably as well. In spite of some optimism about economic recovery, the publishing industry is predicting modest growth, at best, but not enough to absorb a continuing oversupply of paper.

To upgrade the product mix and improve quality, Mead is investing $115 million in two major capital projects that are expected to be completed in 1994 and 1995.

Mead Fine Paper

Mead Fine Paper produces both coated and uncoated papers for business, printing and specialty

uses. The division is also a leading producer of carbonless paper.

Continued weak market conditions and depressed prices held sales growth to a modest increase for the division's Chillicothe, Ohio, mill. However, improved productivity and good cost controls, due in part to capital investments and performance improvement efforts, resulted in significantly increased operating profit for the division. Additional savings and productivity increases are expected for 1994 as a result of continued cost reduction efforts and the effects of capital investment. Mead is investing $111 million to upgrade its coated sheet quality. Earnings growth is expected to be moderate in 1994 in light of the pricing conditions. Despite weak market conditions and depressed prices, 1992 sales were up 6% compared to 1991, while earnings were flat.

The Kingsport, Tennessee, mill continued to be hit hard by market conditions. The mill did not run as well as anticipated in 1993. Sales decreased slightly, and operating results fell significantly compared to 1992.

Mead Specialty Paper

Mead Specialty Paper manufactures saturating papers for use in decorative laminates used in commercial and home construction, remodeling and furniture; and specialty grades in various industrial applications including automobiles.

Sales for 1993 were up slightly from 1992 levels while earnings decreased. Excess global capacity and poor economic conditions in Europe limited growth in 1993. Cost reduction efforts could not offset operating inefficiencies associated with the start-up of a capacity expansion project completed early in the year.

The U.S. housing, remodeling and auto production markets were stronger in 1993 than 1992 and these industries are forecasting a continuation of this trend. The division reported increased sales and earnings in 1992 compared to 1991.

Mead's Specialty division obtained ISO 9001 certification by meeting a set of international standards designed to improve product quality and consistency.

Gilbert Paper

The Gilbert Paper division produces high-quality communications papers, including cotton-content bonds, and specialty text and cover papers.

Gilbert reported slightly lower sales and earnings in 1993 due to reduced volume, a less profitable product mix, merchant consolidations and the weak economy. Productivity initiatives and performance improvement efforts should result in improved 1994 earnings. Sales of recycled grades and laser-compatible sheets continue to grow, as does potential for export growth.

The division reported a modest gain in 1992 sales compared to 1991, while earnings remained flat.

PACKAGING AND PAPERBOARD

Segment Summary ($ millions)	1993	1992	1991
Sales	$1,156.9	$1,163.2	$1,022.8
Comparable earnings	132.8	140.9	106.1
Other expenses		(23.8)	(1.6)
Earnings before income taxes	$ 132.8	$ 117.1	$ 104.5

Sales were essentially flat at $1.16 billion in 1993, and comparable earnings decreased 6%. Sales in 1992 rose 14% over 1991, while comparable earnings increased more than 32%.

A weak global economy and heightened competition leading to pricing pressures were key factors inhibiting growth in this segment. While cost improvements were significant across the divisions, they were not enough to combat difficult market conditions brought on by overcapacity.

Mead Packaging

Mead Packaging is a leading supplier of multiple beverage packaging and packaging systems. It also provides multiple packages of food and other products. Customers include large and small brewers, soft drink bottlers, food and other consumer products companies.

Lower brewery volume and lower than expected growth in the soft drink area, as well as price

pressures, contributed to decreased sales and significantly reduced earnings for 1993 in North America. 1992 sales and earnings were flat compared with 1991.

International earnings were near 1992 levels. Exchange rates, weak European and Japanese economies, and increased pricing pressures were offset by good cost controls.

An ongoing series of cost-effective packaging systems solutions is expected to enhance the division's position with customers overall. To counter worldwide competition and continuing price pressures in the future, the division is intensifying ongoing cost reduction efforts and investing additional capital on productivity improvements for 1994.

Packaging opened subsidiaries in Mexico and Brazil in 1993 and increased its business in Australia. Groundwork has also been laid for new operations in Argentina, Chile and Poland for 1994, as well as other points around the globe.

Mead Coated Board

Mead Coated Board manufactures coated paperboard for use in multiple packaging and folding cartons. Customers include folding carton manufacturers in North America, Europe and Asia, in addition to Mead Packaging's worldwide business.

1993 was the third full year of operation for the expanded Mahrt mill in Alabama. Production increased more than 5% to exceed designed capacity of 800,000 tons. More significantly, production of first quality coated board increased by over 13% as operating efficiency and quality improved, and as sales increases eliminated the need to fill capacity with uncoated board. Despite weaker market conditions worldwide in 1993, sales volume increased 5% primarily due to the folding carton business worldwide. As a result of quality, cost and productivity initiatives, and more favorable results from the division's related wood products operations, earnings significantly improved. However, competitive pressures in the global board market have eroded prices for CNK® paperboard, Mead's coated natural kraft board. Sales rose 14% in 1992 and earnings rose compared to 1991.

The global market for coated paperboard is expected to grow modestly over the next few years. Mead Coated Board, however, expects its sales growth to be above the industry average as market development efforts of the past couple of years take hold.

Mead Containerboard

Mead's Containerboard division produces corrugating medium used in shipping containers and operates eight corrugated container plants.

Solid volume growth in the converting business and good cost controls at the medium mill could not offset the effects of oversupply and price deterioration in both the medium and converted box markets. While sales were flat, earnings decreased compared to 1992. The division doubled its earnings in 1992 compared to 1991.

Independently conducted surveys in customer satisfaction showed the division's medium system has moved to preferred status with its customers. Its Stevenson, Alabama, mill obtained ISO 9002 certification.

Containerboard's inventory levels are stable and demand is on the upturn. It is expected that prices will solidify in 1994, and that additional productivity improvements will drive earnings improvement.

DISTRIBUTION AND SCHOOL AND OFFICE PRODUCTS

Segment Summary ($ millions)	1993	1992	1991
Sales	$1,970.7	$1,954.6	$1,995.7
Comparable earnings	38.4	45.6	36.3
Other expenses	.....	(16.3)	(9.2)
Earnings before income taxes	$ 38.4	$ 29.3	$ 27.1

Sales increased to $1.97 billion for the Distribution and School and Office Products segment while

comparable earnings were down 16% in 1993 versus 1992. Sales include those resulting from the liquidation of inventory purchased from Union Camp's school and office products division. Zellerbach's performance in a poor market and costs associated with productivity improvements and restructuring were the reasons for decline in comparable earnings. 1992 sales were 2% below 1991 primarily as a result of the loss of revenue due to the sale of Ampad Corporation.

Zellerbach

Zellerbach distributes paper, packaging materials and machines, and industrial/commercial supplies in 65 local markets throughout the United States.

Continued price pressures offset the sales gains over 1992 for both the paper and industrial/ commercial supplies businesses. The packaging business continued positive trends in sales growth and margin percentage. Earnings for the division declined significantly in 1993 due to market pressures and the ongoing reengineering of the logistics system, including the consolidation of warehouses and the transition to selective use of third party providers of logistics services. Sales declined slightly in 1992 compared to 1991 but earnings were substantially improved.

Zellerbach accelerated strategic initiatives in 1993, including restructuring and reengineering projects that continue to improve customer

satisfaction ratings, provide a competitive cost structure, and should positively impact performance in 1994. Zellerbach will continue to invest in its long-term growth in 1994.

School and Office Products

Mead's School and Office Products division is the nation's largest manufacturer of school supplies. It also provides stationery products for home and office use, and is an industry leader in fashion and product design.

The division's sales grew 6% in 1993 and 4% in 1992. This excludes sales related to the liquidation of inventory purchased from Union Camp's school supply business in 1993, and 1992 sales of Ampad, a business that was divested in 1992. The 1993 growth was primarily fueled by sales in the Five Star®, Five Star® First Gear™ and Cambridge® product lines.

Pre-tax earnings for School and Office Products increased over 1992 levels due to strong sales and operating performance; 1992 earnings were penalized by losses associated with the bankruptcy of a major customer.

In 1993, the division began to implement fully integrated production planning, inventory control, purchasing and accounts payable systems which are expected to reduce costs over the long term. Mead also entered into a licensing agreement with Nike, Inc.,

which should positively impact the 1994 back-to-school season.

ELECTRONIC PUBLISHING

Segment Summary ($ millions)	1993	1992	1991
Sales	$551.3	$494.8	$469.5
Comparable earnings	50.4	50.6	41.2
Other expenses	.....	(9.2)	(3.0)
Earnings before income taxes	$ 50.4	$ 41.4	$ 38.2

Mead Data Central (MDC) is a leading electronic publisher of legal, business, and financial news and information. Its LEXIS® and NEXIS® information retrieval services are used by professionals in a wide range of disciplines throughout the world.

MDC's sales increased by 11% to $551.3 million in 1993 compared to 1992. However, comparable earnings were essentially flat at $50.4 million, due in large part to strategic investments to enhance the features and functionality of its services, new product development, and costs associated with sales force restructuring. Competitive pressures remained intense, affecting pricing and costs in 1993.

In 1992, sales increased 9%, adjusted for the 1991 sale of a subsidiary. 1992 comparable earnings increased 23% from 1991.

MDC introduced a number of new products and product enhancements in 1993, most notably FREESTYLE™ which enables online users to search the databases using natural language rather than Boolean logic. MDC also added a FINDER® library of current addresses, phone numbers and demographic data on 111 million individuals which helps attorneys locate heirs, witnesses and parties in legal actions. MDC's Folio business released version 3.0 of its electronic publishing software that enables users to create their own information bases for searching and retrieving internal information.

Sales from the business information services area led the way for MDC as it aggressively targeted new business while strengthening relationships with existing customers. The legal information area identified key customer segments and also expanded service to smaller firms.

MDC will continue to focus on market-driven product development and anticipates increased margins in 1994 due to an overall performance improvement effort conducted in 1993, and completion of the amortization of certain intangibles acquired in the purchase of The Michie Company in 1988.

Investees

Mead's primary investees are Northwood Forest Industries, Ltd., a large producer of bleached softwood kraft pulp and wood products in British Columbia, Canada, and Northwood Panelboard

Company, an oriented structural board (OSB) mill at Bemidji, Minnesota. Both are 50%-owned by Mead and Noranda Forest Inc. of Canada. Pulp from Northwood is sold throughout the world by Mead Pulp Sales. Wood products sales are handled by Noranda Forest Sales Inc.

Northwood's 1993 sales were up 12% from 1992. Mead's share of 1993 earnings of all investees was $18.4 million, up from $6 million in 1992. Mead's share of 1991 results was an $18.1 million loss.

Lumber prices were up substantially during the year, more than offsetting depressed pulp prices. Improved housing starts and increased repair and remodeling boosted demand, as did log supply curtailments, particularly in the Pacific Northwest. The industry expects more of the same in 1994, as the outlook is strong.

Pulp prices were weak in 1993. The average domestic price for 1993 was down 19% from 1992 and represents the third straight year of declining prices caused by oversupply, high inventories and sluggish paper markets, particularly overseas.

A gradual improvement in prices is expected for 1994, although full year average prices are expected to remain depressed.

* * *

[EXHIBIT 26—EXCERPTS]

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 1994

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____
Commission File No. 1-2267

THE MEAD CORPORATION
(Exact name of registrant as specified in its charter)

Ohio	**xx-xxxxxxx**
(State of Incorporation)	**(I.R.S. Employer Identification No.)**

MEAD WORLD HEADQUARTERS
COURTHOUSE PLAZA NORTHEAST
DAYTON, OHIO 45463
(Address of principal executive offices)

Registrant's telephone number, including area code: 513-495-6323

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on which Registered
Common Shares Without Par Value and Common Share Purchase Rights	New York Stock Exchange Chicago Stock Exchange Pacific Stock Exchange
9% Debentures due 2017	New York Stock Exchange

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No ___

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

As of January 27, 1995, the aggregate market value of the voting shares held by non-affiliates of the Registrant was approximately $3,037,962,000 determined by multiplying the highest selling price of a Common Share on the New York Stock Exchange—Composite Transactions Tape on such date times the amount by which the total shares outstanding exceeded the shares beneficially owned by directors and executive officers of the Registrant. Such determination shall not, however, be deemed to be an admission that any person is an "affiliate" as defined in Rule 405 under the Securities Act of 1933.

The number of Common Shares outstanding at February 28, 1995 was 57,941,098.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of Registrant's Proxy Statement for the Annual Meeting of Shareholders scheduled to be held on April 27, 1995, are incorporated by reference in Part III; definitive copies of said Proxy Statement were filed with the Securities and Exchange Commission on March 16, 1995.

* * *

As of December 31, 1994, the Board of Directors has restricted cash balances of $331.0 million, included in other current assets, for use in the payment of current tax liabilities related to the gain on the sale of the Electronic Publishing segment and other matters.

M—Discontinued Operations

Discontinued operations consist of the following:

(All dollar amounts in millions)

Year Ended December 31	1994	1993	1992
Earnings from operations of Electronic Publishing segment, net of income taxes of $27.8, $20.4 and $15.8, respectively	$ 37.9	$ 28.4	$ 23.9
Gain on sale of Electronic Publishing segment, net of income tax of $420.2	628.8		
Provision for loss in Insurance operations, net of income tax benefit of $18.2	(33.8)		
Provision for losses in Industrial Manufacturing segment, net of income tax benefit of $9.5	(15.5)	.....	.....
Discontinued operations	$617.4	$ 28.4	$ 23.9

In December 1994, the Company sold its Electronic Publishing segment (Mead Data Central) for $1.5 billion in cash. The financial statements and notes have been reclassified for all periods presented to reflect this segment as a discontinued operation. Revenues of the Electronic Publishing segment were $565.2 million for the period January 1, 1994 through November 30, 1994, and $551.3 million and $494.8 million for the years ended December 31, 1993 and 1992, respectively.

In 1986, the Company adopted a plan to discontinue the insurance business which had been conducted through its wholly-owned insurance subsidiaries and wrote off its investment. These subsidiaries wereput in a "runoff" position whereby they ceased underwriting activities but continued to settle claims. The remaining unsettled insurance claims are long term in nature. During the fourth quarter of 1994, the Company revised its runoff strategy in view of the long-term nature of the payout for claim settlements and sold one subsidiary and settled a significant portion of the outstanding claims liability. The revised strategy includes the disposition of the remaining insurance operations in the near term. As a result, an additional provision for loss on the disposition of the remaining insurance operations has been provided in the statement of earnings. The net liabilities of the insurance operations at December 31, 1994, include total assets of $92.9 million and claims and other reserves of $143.3 million.

* * *

(1) Intersegment sales are made at substantially the same prices and on the same terms as to unaffiliated customers.

(2) The earnings from continuing operations before income taxes includes the effect of the change in the depreciable lives of certain paper mill equipment (Paper—$28.7, Packaging and Paperboard—$14.0) in 1994.

(3) Earnings from continuing operations before income taxes in 1994 include the provision for loss on

the sale of a facility, costs of severance and closing costs for certain warehouses and office facilities and costs of pension settlements. The effect of the above charges by segment is Paper—$65.9, Packaging and Paperboard—$6.9, Distribution and School and Office Products—$17.3 and Corporate and other—$2.7. Included in 1992 are costs of a performance improvement program and a loss on the sale of a subsidiary. The effect of these charges by segment is Paper—$22.3, Packaging and Paperboard—$23.8, Distribution and School and Office Products—$16.3 and Corporate and other—$45.9.

(4) Earnings from continuing operations before income taxes for "Corporate and other" includes the following:

Year Ended December 31	1994	1993	1992
Other revenues:			
(Loss) on sale of subsidiary	$	$	$ (22.5)
Other	(2.5)	3.7	7.7
Interest expense	(101.1)	(94.6)	(99.5)
Comprehensive performance improvement program			(23.4)
Other expenses	(60.3)	(47.2)	(56.2)
	$(163.9)	$(138.1)	$(193.9)

(5) The assets of "Corporate and other" consist primarily of cash and cash equivalents, property, plant and equipment, investments in investees and net assets of discontinued operations.

U—Fourth Quarter Operations (Unaudited)

During the fourth quarter of 1994, the Company recorded several significant transactions, including the sale of the Electronic Publishing segment, a charge for additional losses in its discontinued insurance operations and a provision for environmental remediation costs at two sites formerly part of Mead's previously discontinued Industrial Manufacturing segment (Note M).

The Company recorded a charge to earnings of $60.0 million to reflect the estimated loss on sale of its Kingsport, Tennessee, facility. The Company announced its intent to sell the facility in October 1994. In addition, the Company recorded charges to earnings of $21.3 million, principally for severance and closing costs for certain warehouses and office facilities at its Coated Board and Zellerbach operations; a charge for settlements of pension liabilities of $11.5 million and an extraordinary loss on the extinguishment of debt of $11.3 million (after tax).

Reflected in earnings of equity investees is $9.1 million (after-tax) of refunds from duties levied on lumber exported from Canada by Northwood Forest Industries Ltd. in prior years.

[EXHIBIT 27]

[Excerpts of Mead's Board Meeting Minutes]

12-11-80

The meeting proceeded to consideration of the proposal to liquidate Mead Data Central Inc. and Mead Digital Systems, Inc. as subsidiaries and merge the same into the Corporation. Upon motion duly made and seconded, it was unanimously

MERGER OF MEAD DATA CENTRAL INC.

RESOLVED, That the Agreement of Merger providing for the merger into the Corporation of Mead Data Central Inc. in the form described to the meeting (such Agreement of Merger constituting a Plan of Liquidation of said corporation) be, and the same hereby is, approved and adopted, and the Chairman of the Board, the President or any Vice President and the Secretary or any Assistant Secretary of the Corporation be, and they hereby are, authorized and directed on behalf of the Corporation to execute and deliver said Agreement of Merger.

MERGER OF MEAD DIGITAL SYSTEMS INC.

RESOLVED, That the Agreement of Merger providing for the merger into the Corporation of Mead Digital Systems, Inc. in the form described to the meeting (such Agreement of Merger constituting a Plan of Liquidation of said corporation) be, and the same hereby is, approved and adopted, and the

Chairman of the Board, the President or any Vice President and the Secretary or any Assistant Secretary of the Corporation be, and they hereby are, authorized and directed on behalf of the Corporation to execute and deliver said Agreement of Merger.

FURTHER RESOLVED, That the officers of the Corporation be, and they hereby are, authorized on behalf of the Corporation to execute and deliver any and all documents and papers and to do any and all other acts and things as they may deem necessary or desirable to effect the aforementioned mergers.

7-26-84

CORPORATE OBJECTIVES COMMITTEE REPORT

Mr. Mechem reported on the meeting of the Corporate Objectives Committee held on July 25, 1984. He reported that the Committee had received a very stimulating presentation by Mead Data Central and indicated that the Committee was impressed with the growth and general development of this division and its strong position in the electronic publishing field. The Committee agreed that at the present time the sale or other disposition of this division should not be pursued but rather encouraged management to continue to develop growth plans for this division, including potential acquisitions, and requested that each such acquisition be presented to the Committee for its consideration.

* * *

CAPITAL EXPENDITURES APPROVED

Mr. Raoul-Duval presented proposals with respect to capital project requests to expand Mead Data Central's computer center, and purchase or lease two additional central processing units at Mead Data Central.

Whereupon after discussion, upon motion duly made and seconded, it was unanimously

RESOLVED, That the following major capital expenditure projects be, and the same hereby are, approved:

CPR No.	Plant and Description	Capital Amount
	* * *	
TM-125	Mead Data Central—Phase II Computer Center Expansion	$ 1,650,000
TM-128	Mead Data Central—2 Additional Central Processing Units	$ 7,672,000
	* * *	

RESOLVED, That the Corporation may enter into certain lease agreement(s) with lessor(s) selected by the officer executing the lease(s) on behalf of the Corporation, providing for the leasing of two central processing units and certain related equipment more fully described in said agreement(s) for use at Mead Data Central division for a five-year term with the aggregate rentals not exceeding approximately $7,672,000.

FURTHER RESOLVED, That the lease agreement(s) together with all other documentation required for the transaction may be executed and delivered on behalf of the Corporation by each of the officers of the Corporation in such form and contain such terms and conditions as the officer executing the same shall approve, executing being deemed conclusive evidence of approval, such officers may take such other actions as may be necessary or appropriate to carry out the intent of these resolutions.

———

12-10-93

MERGER OF MDC INTO THE CORPORATION

Mr. Mason presented a proposal to merge Mead Data Central, Inc. into the Corporation which should result in a substantial state tax savings. After discussion led by Mr. Graber and upon motion duly made and seconded, it was unanimously

RESOLVED, That the Agreement and Plan of Merger (the "Merger Agreement") between the Corporation and Mead Data Central, Inc., a Delaware corporation ("MDC") providing for the Merger of MDC into the Corporation effective as of 11:59 p.m. on December 31, 1993, and the assumption by the Corporation of all of MDC's liabilities and obligations, be, and the same hereby is, approved in substantially the form described to the Board of Directors at this meeting with such changes as the officer executing the same shall approve (as conclusively evidenced by the execution of the Merger Agreement).

FURTHER RESOLVED, That the Merger Agreement constitutes a plan of liquidation of MDC subject to Section 332 of the Internal Revenue Code of 1986, as amended.

FURTHER RESOLVED, That the officers of the Corporation be, and each of them hereby is, authorized on behalf of the Corporation to execute, acknowledge, deliver and file the Merger Agreement and any and all agreements, instruments and/or other documents (execution being deemed conclusive

evidence of approval) and to take any and all further action as shall be necessary or desirable in the Officers' sole discretion to carry out the intent of the foregoing resolutions.

MDC CAPITAL EXPENDITURE APPROVED

Mr. Mason presented for approval a proposed capital expenditure to fund the first stage of a capacity expansion, and its development, required in conjunction with the recently in introduced "Freestyle" search system. This expansion includes additional computer capacity and data storage capacity. After discussion and upon motion duly made and seconded, it was unanimously

RESOLVED, That the following capital expenditure project be, and hereby is, approved:

Plant/Description	Capital Amount
Mead Data Central Phase I "Freestyle" capacity	$12.9 million

MINUTES APPROVED

Mr. Palmer reviewed the minutes of the regular meeting of the Board of Directors held on October 30, 1993 and proposed an amendment as follows:

* * *

The minutes were approved as corrected.

* * *

Mr. Mason discussed certain issues and opportunities concerning Mead Data Central, including on-going efforts to explore business alliances, acquisitions and other business strategies and arrangements.

* * *

ADJOURNMENT

There being no further business to come before the meeting, upon motion duly made and seconded, it adjourned at approximately 12:00 noon.

/s/ Thomas E. Palmer
THOMAS E. PALMER
Secretary

Mr. Bogle next presented the capital expenditures for the Mead Data Central Division's incremental computer capacity increase. After discussion and upon motion duly made and seconded, it was unanimously

CAPITAL EXPENDITURE APPROVED

RESOLVED, That the following capital expenditure projects be, and hereby are, approved:

Plants/Description	Capital Amount
* * *	
Mead Data Central Computer Capacity Increase	$9,100,000

LEXIS/COUNSEL CONNECT JOINT VENTURE

Mr. Bogle presented the Committee's recommendation to enter into a partnership with "American Lawyer Media, L.P.," to be known as Lexis Counsel Connect. Upon motion duly made and seconded, it was unanimously

RESOLVED, That the officers of the Mead Data Central division ("MDC") of the Corporation be, and they hereby are, authorized, through one or more subsidiaries of the Corporation, to enter into a partnership with American Lawyer Media, L.P., to be initially known as "Lexis Counsel Connect" (the "Partnership") which will provide an on-line communication system with e-mail and interactive

conferencing capabilities primarily among members of the legal profession in different firms or organizations.

FURTHER RESOLVED, That MDC be, and it hereby is, authorized to contribute not more than Ten Million Dollars ($10,000,000) to the capital of the Partnership.

FURTHER RESOLVED, That the officers of MDC and the Corporation be, and each of them hereby is, authorized to approve the form of and execute, acknowledge and deliver a partnership agreement, any and all certificates and/or documents (execution being deemed conclusive evidence of approval) and to take any and all further action as shall be necessary or desirable to carry out the intent of the foregoing resolutions.

4-27-94

REVIEW OF MEAD DATA CENTRAL

Mr. Mason indicated that the meeting was informational in nature for the purpose of assisting the Board of Directors in connection with evaluating the various strategic and financial alternatives that might be available to the Corporation with respect to the Mead Data Central division of the Corporation ("MDC").

Mr. Mason then presented the results to date of an ongoing project concerning strategic and financial alternatives for MDC. He gave an overview of the project and reviewed the various study teams, research and investigation and the extent of analysis.

Mr. Palmer, Vice president and General Counsel, gave a presentation on the legal responsibilities of the members of the Board of Directors.

Mr. Mason presented the current status of MDC's business with emphasis on its current business environment and prospects with an emphasis on changes since the presentation at the Cabin Bluff meeting of 1993. He then recommended a course of action which included further study of the various alternatives, as well as the possible uses of any proceeds which may be generated. Mr. Mason suggested that it may be appropriate to schedule another meeting in mid-May at which the results of this further study can be reviewed and consideration can be given to the advisability of pursuing a particular course of action.

Messrs. Zimmel and Moore of Goldman, Sachs reviewed the current status of their study of MDC and the various strategic alternatives, their preliminary analysis of the potential values which may be achieved under the various alternatives, and the results of their examination of various issues relevant to a review of the strategic alternatives.

Mr. Atkins of Skadden, Arps, Slate, Meagher & Flom reviewed various potential legal issues relating to alternative courses of action for MDC, including the potential impact on the Corporation.

Mr. Graber, Vice President and Chief Financial Officer, reviewed the potential financial impact on the Corporation of certain of the MDC alternatives.

Ms. Robinson, Vice President, Strategy & Planning, then updated the Board regarding certain issues relating to MDC which she had presented to the 1993 Cabin Bluff meeting.

Mr. Mason set forth a vision for the growth of, and other opportunities relating to, the businesses of the Corporation other than MDC.

Management recommended that no decisions be made at this meeting and the Board of Directors concurred.

MDC/DOW JONES AGREEMENT

Mr. Mason then presented a proposal that the Corporation enter into an agreement with Dow Jones & Company, Inc. for the Corporation's Mead Data Central Division to distribute certain Dow Jones' publications and discussed the proposed terms and conditions of such agreement. After discussion and upon motion duly made and seconded, it was unanimously

RESOLVED, That a special committee of the Board of Directors composed of John C. Bogle, Steven C. Mason and Thomas B. Stanley, Jr. be, and hereby is, delegated full authority to approve an agreement between the Corporation and Dow Jones for distribution by the Corporation of certain Dow Jones publications upon such terms and conditions as the Committee deems appropriate and advisable.

MINUTES APPROVED

The minutes of the regular meeting of the Board of Directors held on February 24, 1994 were approved as submitted to the Directors.

5-14-94

ACTION ON MEAD DATA CENTRAL

Mr. Mason commenced the meeting by discussing management's view as to the basic values which may be achieved upon a divestiture of the Mead Data Central division of the Corporation ("MDC").

Mr. Palmer, Vice President and General Counsel, reported to the Directors on the efforts of Goldman, Sachs & Co. ("Goldman, Sachs") since the Directors' meeting in April. Mr. Palmer responded to a question regarding any update to Goldman, Sachs' view as to the likely price range to be realized from a sale of MDC. He also discussed the fee to be paid to Goldman, Sachs for their services in the transaction. Mr. Palmer responded to questions concerning ongoing relationships with suppliers and competitors.

The Board next discussed the proposed process to be followed in selling MDC. A proposed press release was reviewed by the Board of Directors and they agreed with it in concept with no substantive comments.

The Board discussed with Mr. Mason retention plans for MDC employees.

Messrs. Mason and Graber reviewed pro forma financial projections which had been submitted to the Directors in advance of the meeting, reflecting the potential impact on the Corporation of the sale of MDC. Discussion and questions followed.

After considerable discussion by the Directors, Mr. Palmer at the request of Mr. Mason called on each individual Director giving each an additional opportunity to raise any remaining questions.

A draft resolution which had been submitted to the Directors in advance of the meeting was discussed. Upon motion duly made and seconded the Directors unanimously adopted by roll call vote the following resolution:

RESOLVED, That having made a decision to focus on Mead's core forest products businesses—paper, pulp, packaging and paperboard, and distribution and school and office products—the Board of Directors hereby authorizes the Officers of the Corporation to explore divestiture alternatives for Mead Data Central which would maximize the value of Mead Data Central for the Corporation and its shareholders and further authorizes the retention of Goldman, Sachs & Co. to assist the Corporation in evaluating those alternatives.

ADJOURNMENT

There being no further business to come before the meeting, upon motion duly made and seconded, it adjourned.

/s/ Thomas E. Palmer
THOMAS E. PALMER
Secretary

08-04-94

JOURNAL GRAPHICS ACQUISITION

Mr. Mason presented information on Mead Data Central's ("MDC") proposal to acquire Journal Graphics, Inc. at a price of approximately $3,000,000 initially plus an earn out with a present value of an additional $3,000,000. The proposal included a standstill agreement for which the Corporation would pay for $200,000. After discussion and upon motion duly made and seconded, it was unanimously

RESOLVED, That a special acquisition committee (the "Acquisition Committee") of the Board of Directors composed of John C. Bogle, Steven C. Mason and Thomas B. Stanley, Jr. be, and hereby is, delegated authority to approve the purchase of any or all of the capital stock of Journal Graphics, Inc., or any or all of the assets of Journal Graphics, Inc., such acquisition to be upon such terms and conditions as the Acquisition Committee deems advisable.

* * *

EXECUTIVE SESSION

The meeting then continued in an Executive Session.

ADJOURNMENT

There being no further business to come before the meeting, upon motion duly made and seconded, it adjourned.

/s/ Thomas E. Palmer
THOMAS E. PALMER
Secretary

The Committee also approved modifications to the Corporation's compensation programs effecting employees of Mead Data Central Division upon the close of its divestiture. Awarding of performance bonuses in the form of restricted stock or stock options to six senior executives who made significant contributions to the successful divestiture of the Mead Data Central Division, contingent upon the close of such divestiture, were approved by the Committee.

[EXHIBIT 35—EXCERPT]

PROPOSED MERGER OF MEAD DATA CENTRAL INTO MEAD CORPORATION

Background

Mead Data Central, Inc., a wholly-owned subsidiary of The Mead Corporation, was incorporated as a separate company in 1985, primarily for strategic and tax purposes.

Current Situation

It has been determined by Mead's Tax Department that a merger of Mead Data Central into Mead Corporation would result in substantial state tax savings. Estimated annual savings range from $1.2 million for 1994 increasing to $2.5 million by 2007 (based on current projections). The savings will occur primarily because Mead will be able to utilize net operating loss carryforwards which might otherwise expire unused.

A merger requires the approval of the Boards of Directors of The Mead Corporation and Mead Data Central, but no shareholder approval is required. It is expected that a merger can be completed by December 31, 1993.

It is estimated that the cost to complete the merger and related actions will be $350,000.

Recommendation

That the Board of Directors approved the merger of Mead Data Central, Inc. into The Mead Corporation.

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[EXHIBIT 37]

LIQUIDATION/MERGER
MEAD DATA CENTRAL INC.
MEAD DIGITAL SYSTEMS, INC.

CURRENT SITUATION

Mead Data Central Inc. and Mead Digital Systems, Inc. both operate as wholly-owned subsidiaries of Mead. Due to the stage of market development, the nature of their business, and similar matters, these two business units are not currently as profitable in relation to sales, assets employed and payroll as other segments of Mead. As separate corporations they pay state income taxes based on their separate corporate results. For U.S. income tax purposes, they are included in Mead's consolidated U.S. income tax return.

PROPOSED CHANGE

It is proposed that Mead Data Central Inc. and Mead Digital Systems, Inc. be liquidated/merged into Mead and be operated as separate divisions. As divisions of Mead, the financial results of their operations, consolidated with the rest of Mead, would result in a projected combined net state income tax savings of $3.0 to $5.0 million over the next five years.

To facilitate the continuation of business after such liquidation, it is also proposed that Mead's officers be given the authority, from time to time, to qualify Mead as a foreign corporation in any state in which

such qualification may be necessary or desirable or to withdraw from such qualification when it becomes no longer necessary or desirable. No such general authority currently exists.

RECOMMENDATION

That the Board of Directors authorize management to proceed with the liquidation/merger of Mead Data Central Inc. and Mead Digital Systems, Inc. into Mead and to qualify Mead as a foreign corporation or to withdraw from such qualification as may be necessary or desirable.

Board of Directors
December 11, 1980
RBM:jn 2

STATE OF ILLINOIS)
) SS.
COUNTY OF COOK)

IN THE CIRCUIT COURT OF COOK COUNTY
COUNTY DEPARTMENT—LAW DIVISION

MEAD CORPORATION, Plaintiff, vs. ILLINOIS DEPARTMENT OF REVENUE, GLEN L. BOWER, DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE, and JUDY BARR TOPINKA, TREASURER OF THE STATE OF ILLINOIS, Defendants.	No. 00 CH 7854 Transferred to Law Division

VOLUME I (PAGES 1-113)

REPORT OF PROCEEDINGS at the trial of the above-entitled case before the HONORABLE ALEXANDER P. WHITE, Judge of said Court, on the 20th day of March, 2002, at 10:20 a.m.

* * *

[18] A Yes, I was employed by Mead Data Central from the '76-'77 time frame to the end of my career in 1991 at Lexis.

Q What I'm going to do is refer to Mead Data Central as Lexis-Nexis from here on in.

A Yes.

Q Just consistent with our stipulation.

What position did you hold with Lexis-Nexis when you first started with Mead?

A I was head of operations, reporting to Ed Gossman, who was the chief strategic officer. And about a year later I was vice president of operations reporting to Jerry Rubin, who was the CEO of Lexis-Nexis.

In 1981-'82 I was acting president for two years. And then when Jack Simpson came on, who was the then president of Lexis-Nexis, I was general manager for Lexis and Nexis, and then just general manager for Lexis until I retired in—well, until '89. And then in '89 I was head of the Micchie Group, which was the Micchie Company, state statutes and things like that.

Q Do you know how the name Lexis was created?

A Yes.

Q Can you describe that for us?

A In around 1968, Mr. McSweeney bought a company [19] from his neighbor that had a couple things in it. They were very interested in the ink jet printing and how it would affect Mead. There was also some recognizance technology that was used on the Gemini flights and for recognizance flights in the military. And there was a full-text information retrieval product that was a result of a request for

proposal to the Air Force base in, at Wright-Patterson Air Force Base in Dayton, that they bid on, and that was one of their products, a full-text retrieval product.

Q Who was McSweeney?

A McSweeney was the chairman of the board of Mead.

Q You mentioned that when this Data Corporation was acquired in '68, one component was—was it Lexis-Nexis or the predecessor to Lexis-Nexis?

A Lexis-Nexis did not come about until 1973. What happened is about the same time as Mead bought this product, there was activity in Ohio and in Missouri by the bar association as to whether there was a better way to do legal research. So to make a long story short, Mead worked with the Ohio Bar Association and the Missouri Bar Association and created a product called MOH Bar, which took this software and applied it to the law in those two states, and they ran that product and [20] learned a lot up through '72, at which time it was stopped. What they learned from that, we redid the software and reconstituted the product and realized that you couldn't be very successful with Missouri and Ohio law, you had to have federal and larger states and more comprehensive product. And Lexis was relaunched in 1973 as Lexis, that was the beginning of Lexis.

Q That was the beginning of Lexis in 1973. And was it successful immediately?

A I wouldn't think so, no. I mean it's hard to put the Court back in that time frame. In 1973 people weren't computer literate, there were no Telenets or Timenets. We had to build our own keyboards, our own software, our artificial intelligence, telecommunications, front-end processors, NODAL networks, all those kind of things, and it took a while for Lexis to become successful. On a monthly basis, Lexis became profitable in late 1978, and thereafter it was cash-positive.

Q When did Lexis first become being used often by law schools and courts?

A It was gradual from '73. But the big event that really helped was the '74-'75 time frame when Bob Britton, who was one of our vice presidents, had an [21] audience with one of the Supreme Court Justices, he had like five minutes, and that justice had his clerks working on trying to find some precedent for about six, eight weeks, and they couldn't find any. Lexis found some remarkable precedents in a few searches. Bob ended up presenting to the whole court. The court became a customer very shortly thereafter. Once the court became a customer, courts like this became a customer, and then law firms around the United States needed to have Lexis. And so it was clear after '75-'76 that we were going to make it, it just took

volume to get us to '78 where we finally had enough volume to be profitable.

Q So by '78-'79 you were profitable?

A Yes.

Q Was there any competition with Lexis during this time period?

A Well, competition during that time was basically the manual process. You had a whole generations of lawyers who were used to the key numbering system. But as far as an electronic process, there was no competition at this time.

Q When did competition, serious competition, from the electronic world come about?

A Westlaw came out with a headnotes-only system in [22] the late '70s early '80s, which was not very successful. And they really copied our system and came out with a system as a secondary to the headnotes only system in the early '80s, and it became truly competitive by about 1985, somewhere in that time frame.

Q So through '85 there was no serious competition?

A That's correct.

Q Now, you mentioned in the '78-'79 time period the company became profitable, Lexis-Nexis. Was there any change in the '79 time period as to how customers could use Lexis?

A There were a lot of technology hurdles that we had to overcome. One of the difficulties were if—all terminals back in—it's hard to even explain this—all terminals back in that time were basic corded keyboards. And if you used Lexis, you used dot commands, like dot PF for page forward, dot BF for back, for page backward, BF for page backward.

We invented the, called the UBIC, which is the little red terminal that probably a lot of you, who are lawyers, have seen. We put those in law firms around the country. They had function keys on them. They had an auto-dialer on them so you could push page forward, page backward. You could push the auto-dialer and it [23] would automatically sign you into Lexis. And that was really the genesis of lawyers using Lexis. Because no longer did they have to do down to the library, it was on the desk behind them. And it really boosted our use quite a bit.

Q You stated that the UBIC had a function. What was the function, like the next page button?

A Yes, there was a page forward, page backward, there was a segment key, there was a citation key, there were lots of different keys on those keyboards for really ease of use, to make lawyers and judges be able to use the system without knowing an arcane language like dot PF.

Q Were you directly involved in the creation of UBIC?

A Yes, I was—I drew it on a napkin one night and a gentleman named Bob McConnell, who is a technical hardware genius, three weeks later had it working as a prototype.

Q Was the Mead Paper Company involved in the creation of UBIC?

A No. Mead had very little involvement in almost anything we did.

Q Starting in 1980, did anything happen with [24] respect to the facilities where Lexis-Nexis was located?

A Yeah. Up to 1980 we were located, with the small number of personnel we had, in the Mead world headquarters building, and we also bought CPU cycles from the corporate computer center.

By 1980, Lexis was growing so rapidly that it was clear that we were going to expand greater than this computer center could expand. Because it was on the 16th floor of a high-rise building, and you couldn't go up or down, that was the limitation. So we were asked to move. We built a building in Miamisburg, which became our computer center headquarters, and all of our people then were moved to Miamisburg.

Q Where is Miamisburg?

A About 15 miles south of Dayton.

Q And you mentioned that prior to the 1980 move that people were located in Dayton. Was Jerry Rubin and other people located there also?

A No. All the operations were in Dayton, Ohio, and the headquarters were always in the PanAm Building in New York. And what was in the headquarters building was Jerry Rubin, the executive office, the head of sales, head of strategy, and chief legal officer. And then all of operations were in Dayton, Ohio, reporting to me.

[25] Q And this Building 1 was created in 1980. Can you describe Building 1 to us?

A Building 1 was built as about as secure a facility as you could build for running a computer center which all your revenue comes through. It also housed about 200 people in the operations area. It had some very complex technology, like dual routing of power lines, dual routing of networks, so we could give you 100 percent availability. It had backup generators. It had backup wells, in case the air conditioners didn't work, so you could run water through the computer systems to cool them and all that kind of stuff. So it was a very complex building. It still runs today. It's very, very highly reliable.

Q Did the relationship between Mead and Lexis change after 1980 when you moved into Building 1?

A No, it was basically the same. The relationship between ourselves and Mead was very simple. They weren't lawyers, so they didn't know the law. They didn't know how to build databases. They didn't understand technology. They didn't understand NODAL networks. These were people that invested in something. They put people there that they trusted.

Once a year we would go to see them and present a [26] business plan. And that was pretty much the interaction between ourselves and Mead unless they had a question.

Q Were there Mead executive conferences that you attended?

A Yes, I did.

Q Can you describe that to us?

A If you were one of the top 30 or 40 people in Mead, you were invited to the executive conferences. I went for a while. They really dealt with issues that were relevant to Mead, which were stumpage, pulp, brown paper, white paper. I went for about two years and I didn't go anymore.

Q Why did you stop going?

A It wasn't anything relevant for us to do and, honestly, the cultures were so different that it really just was a waste of time.

Q I believe you mentioned earlier that you became acting vice president in 1982; is that correct?

A I became acting president.

Q Acting president, I'm sorry.

A Yes. I was already a vice president.

Q What were your responsibilities at that time?

A Everything. And everything reported to me—Lexis-Nexis, accounting, sales, everything.

* * *

[29] BY MR. FIELDS:

Q And the difference between the Lexis and the Nexis would you briefly discuss?

A Well, Lexis was a very elegant, complex system for helping lawyers find the cases that they needed, including things like interfacing the Shepard's, interfacing the auto-cite, interfacing the treatise material, jump citing, and all that kind of stuff.

Nexis was a news and periodical and business product including information from the SEC, et cetera, to help business people find out people, places, things, and things to help them do their job.

Q Was Nexis successful in the early '80s?

A No, Nexis was not successful. It was launched in the early '80s, '79-'80 time frame, and it took about four or five years before it was profitable.

* * *

[31] A After Mr. Simpson came in and assumed responsibility as president, I was immediately responsible for both Lexis and Nexis. And as Nexis grew, it was given to another executive to spend full time on, and I spent full time as general manager and head of Lexis. So everything under Lexis reported to

me, technology, database building, acquisition of data, sales, everything.

Q You mentioned Building 1 earlier. Were there any other buildings involved with Lexis-Nexis?

A Yes. We wanted to create a—I was responsible for building Building 1. And my view was that if Lexis was going to make it, we wanted a campus environment. So we built Building 1 in a wooded area. We had about, I don't know, 50-60 acres, I guess. It ended up being the house—it ended up being the site for six buildings, including things like running track, showers, cafeterias, and all those things you need for a high-tech environment.

Q Did Mead's office building have similar type items, baseball diamonds and—

A No, . . .

* * *

[33] Q Was there an internal security department?

A Yes, there was.

Q Did Mead's senior management have complete access to the Lexis-Nexis facilities?

A No, they were guests.

Q Can you elaborate on that, what that means?

A If someone from Mead wanted to see us, they could get into the lobby and they had to be then escorted to whoever they wanted to see.

Could you compare the corporate cultures between Lexis-Nexis and Mead?

A Well, Mead was a $4 billion paper company that was basically growing at the GNP. It was a more or less slow moving, very structured, highly structured kind of a company.

Lexis-Nexis was very entrepreneurial, high-risk, long working hours, running tracks, everything you could do to keep people working to see if you could overcome these hurdles. Because if you go back to 1972 and look at the computer power, the disk drives, the telecommunications, it was a low probability you were going to get this thing to work. And so we had to invent a lot of things. We invented the first multiplexers. We [34] did the first NODAL networks. We did the first auto-dialers. We did the first function keys. We invented search technology that today is still written about. So all those things were very complex things that were happening in this time frame, very entrepreneurial, very almost free-flowing. If you had a great idea, run with it, because we had to figure out how to do this stuff.

Q Now, when you were working at Lexis-Nexis, did you have any business cards?

A Yes, I had two sets.

Q Could you describe them?

A We were known by Lexis and Nexis in the industry. If I wanted to get into a judge's chambers or the White House or the Supreme Court, if I gave my Lexis card, I could get in. We also had to have Mead cards because Mead executives wanted us to carry those and we used them when we were with Mead executives.

Q Did Lexis-Nexis provide bonuses to its employees?

A Yes, they did.

Q Could you describe how those bonuses were computed?

A There were really two types of bonuses. For the executives, they were based on the performance of Lexis

* * *

[36] A No. Other than, as I said, we had basically a meeting every year to explain our business plan and that was pretty much it.

Q Did Mead have any involvement in pricing for the services that Lexis-Nexis charged?

A Never.

Q Could a customer of Lexis-Nexis receive a discount from Mead if they bought Mead paper?

A No.

Q What about a customer of Mead, did they receive a discount on Lexis-Nexis service?

A No.

Q Did Mead and Lexis-Nexis have a similar customer base?

A No. I mean there were certain businesses that probably bought Mead paper and also bought Lexis. But we sold to lawyers, accountants, judges, law schools. They sold to merchant houses, brown box companies, school supplies.

Q Did Mead use the Lexis-Nexis service?

A They did.

Q Did they receive a discount for using that service?

A No. They were billed as a regular customer and [37] they paid us as a regular customer.

Q Were they a significant customer?

A They were very insignificant actually.

Q When you were at Lexis-Nexis, how was the entity Lexis-Nexis legally structured?

A In the early days, based on my recollection, we were a division. And we were changed to a subsidiary, I believe, sometime in the '80s. We may have been changed back.

Q Did the legal structure affect the operation of Lexis-Nexis at all?

A No. The only thing I remember, one day I was at my summer home and they needed me to sign papers to change it. And that was the extent of the involvement and the extent of the knowledge. It didn't affect any—I don't think anybody else even knew, at least at Lexis-Nexis.

Q Did Lexis-Nexis have its own research and development department?

A Yes, we did.

Q Was that department shared at all by Mead?

A No.

* * *

[39] Q It's been stipulated that there were no regular transfers of personnel between Lexis-Nexis and Mead. Why were there no transfers of personnel, regular transfers?

A Well, with the exception of a few unique individuals that either had a strong technology background or a strong legal background, or later on maybe an accounting background, as we grew, there just wasn't the same type employment. I mean Mead was hiring woodsmen and paper marketers and machine operators. And we were hiring software people and lawyers and people that sold to different type of clientele.

Q Did Mead and Lexis-Nexis jointly purchase many items?

A None that I know of.

Q Why did they not make joint purchases?

A Well, basically we purchased different things. I [40] mean we purchased computer hardware in large volumes, different computer hardware than Mead used. We purchased office supplies, but we purchased them through our own purchasing department. And so basically, basically we ran as a separate company.

Q It's been stipulated that Mead and Lexis-Nexis did not share manufacturing facilities, they did not share selling facilities, they did not share distribution facilities. Are you aware of any facilities that Lexis-Nexis share with Mead?

A Other than the earlier time frame when we were in the world headquarters just as an accident, no. We were completely separate. There was one overlap, by accident also, in the PanAm Building in New York. We were on the 43rd and 44th floor. Mead had an office on the, I think it was the 12th floor. But they were separate contracts. We didn't share conference rooms. We didn't even know they were there until they told us.

Q Did Mead play any role in supervising the day-to-day operations of Lexis-Nexis's business?

A None whatsoever. And it's really very logical. These were paper people, and we were dealing with very complex, technical database issues. They just didn't have the experience.

[41] Q Did any individuals involved in the management of Lexis-Nexis, were they also involved in the management of Mead?

A No.

Q Was Mead's approval needed by Lexis-Nexis to make day-to-day business decisions?

A No.

Q What about for capital acquisitions?

A There was a capital acquisition structure which Mead put in, and changed over time, which gave us different authority levels to do different things. But even that was not really enforced. I know I was told by Mead early on: Listen, if it's computer gear, buy it. We don't know what you're doing. You know, you told us what your growth rate and your plan is, do it.

Now, they wanted to see, if we were going to buy a company, they wanted to see it; if we were going to build a new building, they wanted to see it. But basically, short of that, we were told to run our business.

Q Did Mead maintain any committees that monitored the activities of Lexis-Nexis?

A Not to my knowledge. And I was involved in almost every meeting from 1976 through '91.

[42] Q You mentioned earlier that Mead was a customer of Lexis-Nexis?

A Yes.

Q Are you aware of any other intercompany transactions between the two businesses?

A In the late '80s we bought a company called Micchie, which I testified that I was then later president of Micchie Group. Micchie not only—well, Micchie was a statute publisher that published in 19 lesser states basically. And occasionally Micchie would buy paper from Mead. But even in that case, Mead probably supplied maybe 10 percent of the paper. Ninety percent of the paper was bought by other people, bought by other companies.

Q Now, you said "we bought Micchie." Who was "we"?

A Lexis. Lexis bought Micchie.

Q And was any discount received from Mead when that paper was bought from Mead?

A No. That's why we bought a lot of paper from other people.

Q How would you describe Mead's ownership of Lexis-Nexis?

A They were an investor.

* * *

[44] CROSS-EXAMINATION

BY MR. FLIFLET:

Q Mr. Roemer, as I understand it, you were not involved with either Mead or Lexis-Nexis during '93 or 1994, the years in question here; is that correct?

A That is correct.

Q Are you being compensated for your testimony here this morning?

A No, I am not.

Q You mentioned that Lexis began operations around 1973; is that correct?

A That's correct.

Q And then it became profitable in around 1978 or 1979; is that correct?

A That's correct.

Q Who was providing the capital to build the business during those years before it became profitable?

A Mead provided us the capitalg.

Q Thank you.

* * *

[50] Q From an operational standpoint, how did Lexis-Nexis interact with Mead?

A It didn't.

MR. GOLDSMITH: Objection. Can you state a time frame when you're asking for these relationships?

MR. FIELDS: Certainly.

Q During the time from 1984 to 1994, first when you were with Lexis-Nexis and then when you were with the Mead Corporation, from an operational standpoint, how did Lexis-Nexis interact with Mead?

A To the best of my knowledge, on a day-to-day operating basis, there was no interaction. There were periodic strategy reviews, business plan reviews, but there were no day-to-day interactions that I'm aware of.

Q Did Lexis-Nexis have its own operating officers?

A Yes.

Q And what did those officers do?

A They directed the day-to-day operations of the company. They were responsible for the development of longer term strategies and funding requirements. They approved initiatives and projects to grow the business.

* * *

[52] Q Now, it's been stipulated that Lexis-Nexis maintained its own marketing department which did its own advertising. Are you aware of any joint advertising between Lexis-Nexis and Mead?

A None.

Q Did Lexis-Nexis assist Mead with any of its advertising?

A No.

Q Do you know whether Lexis-Nexis—

THE COURT: Can I ask one question?

MR. FIELDS: Certainly, please.

THE COURT: In respect to advertising, where they had the Lexis-Nexis name, was there anything about a subsidiary of Mead?

THE WITNESS: I know that we used Mead Data Central. I'm not sure what the tag line was. I actually, I can't remember it. We were primarily going to market, though, as either Lexis or Nexis, that's where the brand equity was, that's where our customers understood us.

BY MR. FIELDS:

Q If you look at an advertisement, what would be the most prominent part of the advertisement? If it did say Mead Data Central also, would that be the most [53] prominent, or would the Lexis-Nexis?

A Nexis, Nexis or Lexis. I mean that was the brand against which we were known. That did lead to a lawsuit between Mead Data Central and Toyota over the introduction of the car Lexus. There was a

lawsuit back in the late '80s over that, which we ultimately lost, but we tried.

Q Did Lexis-Nexis have its own internal security department?

A Yes.

Q Can you describe that for us.

A Sure. It was headed up by a director by the name of Jim Anderson, whose background was Big Six consulting, and I believe at some point in time he was employed by the U.S. Secret Service. He was responsible both for information technology security as well as physical security. We had a lot of it.

Q A lot of it?

A A lot of it.

Q Did Mead also use this internal security department?

A No.

Q Now, it's been stipulated that Lexis-Nexis maintained it own human resources department and its own [54] marketing department. Are you aware of any departments that Lexis-Nexis shared with Mead from the time you began at Lexis-Nexis in 1984 through your time at Mead in 1994?

A No, there was no overlap.

Q Are you aware of any facilities that Lexis-Nexis and Mead shared at the time you were there?

A No.

Q Now, it's been stipulated that there is no regular exchange, or there was no regular exchange, of employees between Lexis-Nexis and Mead. And yet you started with Lexis-Nexis and now you're at Mead.

A I was the exception.

Q You were the exception?

A Right. There was, over the course of the time that I've been with the Mead Corporation, now MeadWestvaco, there may have been a half a dozen people out of, I don't know, a total population of about 4,000 employed by Mead Data Central, who transferred from Mead Data Central to the corporation in various capacities.

Q Were you transferred from one business to the other?

A Transfer is probably not the right word. In 1992 I had made a decision that I was going to leave Mead Data Central for personal reasons. I wanted to remain in the [55] Dayton area, so I applied for a position at the corporation in the strategy department and was hired.

Q That was a separate application?

A Nothing as formal as an application, but it was a separate initiative, let's put it that way.

Q Why were there so few transfers between Lexis-Nexis and Mead?

A Very, very different businesses. Very, very different cultures. Very different careers. I had basically, prior to joining Mead Data Central, had begun my career with University Microfilms, had worked for Memorex and high technology companies and then for some publishing companies. So Mead Data Central, as an electronic publishing company, the sort of integration of intellectual content and information technology coming together to form the basis for making money was a sort of unique business venture. To leave that market and go to the headquarters of a Fortune 500 company basically said you were making a career choice which would preclude your going back because things change so fast. So I made a career decision in 1992. Most people weren't prepared to make that career decision. If they were going to leave Mead Data Central, they'd leave to go to a publishing company or a technology company.

[56] Q How were bonuses computed for Lexis-Nexis while you were there?

A Entirely on the performance of the business against its business plan.

Q Were there ever situations that arose where employees of Lexis-Nexis received a bonus in one year but Mead's employees did not?

A Most of the years that I was employed by Mead Data Central.

Q In most of the years that occurred?

A Yes.

Q What type of approval was needed from Mead for Lexis-Nexis to engage in day-to-day business operations?

A None that I'm aware of.

Q What about approval for capital acquisitions?

A I think, to the best of my knowledge, there was a capital approval process that said above a certain signature, or above a certain capital level, you would get approval from the chairman. So I'm not sure what those limits were.

Q Did Mead ever have to go to Lexis-Nexis to seek approval for anything?

A No.

* * *

[68] A There was, from an operational standpoint, there was little interaction. I think it was testified to earlier by Mr. Roemer and Mr. McGrane that there was an annual strategy review where the Lexis-Nexis strategy was reviewed or presented to

the corporation. And then there was what we called the business plan review where it would be more the operating plan for the next year, the profit plan for the next year, essentially here is what we expect in terms of profits and cash to be delivered to the corporation.

Q How was Lexis-Nexis legally structured?

A Well, it was—

MR. GOLDSMITH: Objection. Give us a time frame.

MR. FIELDS: Sure.

Q As CFO, did you become aware of how Lexis-Nexis was legally structured during any time frame from the mid '80s through your tenure with Mead, I guess current, through '94, when it was sold?

A As CFO of the Mead, previously CFO of the Mead Corporation, I became aware that it had changed between a division of the corporation and a subsidiary of the corporation over time. I am familiar with the last time that it was changed from a division to a subsidiary. It was about the time that I was leaving that business and [69] moving on to a new role.

Q During that last change while you were there, the change in legal structure, did that affect the operations of Lexis-Nexis at all?

A Not at all. There was probably a handful of people in either Lexis-Nexis or in the Mead

Corporation that would have had any idea that it was being changed. The legal staff at Lexis-Nexis was not particularly pleased at it because it meant a lot of work and redoing contracts and so forth. But past that, I don't think there were more than a handful of people that would have known.

Q Was Mead involved in the day-to-day operations of Lexis-Nexis?

A Not at all.

Q Not at all?

A Not at all.

Q Did Lexis-Nexis have its own real estate department?

A Yes, it did. It reported to me.

Q It reported to you?

A Uh-huh.

Q And did they provide services for Mead at all?

A No.

[70] Q Did Lexis-Nexis have a purchasing department?

A Yes, it did.

Q And did that have regular interaction with Mead Corporation?

A No. It also reported to me, and it had little or no interaction with Mead purchasing department.

Q What about a security department, was there a security department at Lexis-Nexis?

A Yes, there was

Q And did Mead use the same department?

A No.

Q They were separate?

A Very separate. It was a much more extensive security department at Lexis-Nexis than Mead would have had. I'm not sure in those days that Mead actually had a security department, but Lexis-Nexis had a very rigorous security program.

Q Did Lexis-Nexis and Mead each have their own separate payroll departments?

A Yes.

Q What about a policies department?

A Yes.

Q They were separate?

A Yes.

[71] Q Are you aware of any departments that Lexis-Nexis shared with Mead?

A No.

Q Did Mead and Lexis-Nexis jointly purchase raw materials?

A No.

Q Did they jointly purchase many items?

A I'm sure there was some commonality in some of the office supplies that they purchased; but to the best of my knowledge, there was never any joint purchasing activity.

Q Why is that?

A Well, from the raw materials standpoint, I'm sure that there was virtually no overlap in the types of raw materials that they would have purchased. I mean Mead purchased trees and stumpage and pulp and those sort of things, clay coatings, and so forth. And the types of things that Lexis-Nexis/Mead Data Central would have purchased would have been computer equipment and those types of things. Mead Corporation's information systems department presumably was purchasing some of the same types of things, but to the best of my knowledge there was no joint effort to leverage purchase contracts there either.

* * *

[73] BY MR. FIELDS:

Q Did Lexis-Nexis provide technical assistance to Mead?

A No.

Q Can you please describe any intercompany transactions that you are aware of.

A Mead did a cash sweep. So to the extent that there was cash residing in Lexis-Nexis's bank accounts, that cash would have been swept into an account so that it could be invested. That was the most significant one.

I'm sure that over time there was probably some Mead paper that came in to the Lexis-Nexis business, although that was more coincidental than anything else. It was not because it was an intent to move that paper through, but rather in the marketplace Mead Corporation had probably, in most of its grades of paper, 10 percent market share, and probably a proportionate share of that paper would have migrated through the Lexis-Nexis.

EXAMINATION

BY THE COURT:

Q You mentioned a cash sweep conducted by Mead to invest excess cash?

A Right.

[74] Q Could Nexis-Lexis have done that themselves? In other words, they have their own sweep, they go out and say, hey, we've got some extra cash, we've got to cover our cash flow, and therefore why don't we invest this?

A They could have done so. They had a treasury department. It was, you know, they could have set up the banking relationships, the extensive banking relationships, and so forth, to do so, but chose not to.

MR. FIELDS: Nothing further, your Honor. Thank you.

THE COURT: Cross.

CROSS-EXAMINATION

BY MR. GOLDSMITH:

Q How often did Mead do these cash sweeps?

A I'm not sure exactly. I think it was probably on a nightly basis.

Q And this cash that was swept, that was invested according to whatever investments Mead decided to invest it in as opposed to Lexis-Nexis?

A Right.

MR. GOLDSMITH: No further questions.

FURTHER EXAMINATION

BY THE COURT:

Q Did they invest that then? Were those [75] investments made on behalf of Mead or Lexis?

A There was separate accounting—

Q Who did it accrue to?

A To—the investments were—the cash essentially was always attributable to Lexis-Nexis. There was separate accounts maintained and it would have been treated from an accounting standpoint as a—

Q So the investments that were made from the excess cash then accrued to the benefit of Lexis?

A That's correct.

* * *

STATE OF ILLINOIS)
) SS.
COUNTY OF COOK)

IN THE CIRCUIT COURT OF COOK COUNTY
COUNTY DEPARTMENT—LAW DIVISION

MEAD CORPORATION,) No. 00 CH 7854
) Transferred to
Plaintiff,) Law Division
)
vs.)
)
ILLINOIS DEPARTMENT OF)
REVENUE, GLEN L. BOWER,)
DIRECTOR OF THE ILLINOIS)
DEPARTMENT OF REVENUE,)
and JUDY BARR TOPINKA,)
TREASURER OF THE STATE)
OF ILLINOIS,)
)
Defendants.)

VOLUME II (PAGES 114-221)

REPORT OF PROCEEDINGS at the trial of the above entitled case before the HONORABLE ALEXANDER P. WHITE, Judge of said Court, on the 20th day of March, 2002, at 1:45 p.m.

* * *

[185] VOIR DIRE EXAMINATION

BY MR. FRANKEL:

Q Mr. Murray, this is the work papers you prepared for this case?

A No, this is work papers I prepared for the audit.

Q For the audit that precipitated this case?

A Correct. Well, it has some information on here for '93 and '94, but, yes, these were the papers I prepared.

Q And when did you prepare those?

A The dates are in the top right-hand corner. Most of them are April of '97 and March of '98.

MR. FRANKEL: No objection, your Honor.

THE COURT: Defendants' Exhibit A will be admitted into evidence.

DIRECT EXAMINATION (Cont'd)

BY MR. FLIFLET:

Q Would you show us on your work papers how it is that you apportioned the gain from the sale to Illinois?

A Well, it's about the fifth page from the back. What I did was, in the first section here—

[186] Q What is the page title?

A It says, "Illinois Sales of MCD Disposal."

Q Proceed.

A What I did in the top part of this is took Illinois property and divided it by the total MDC

assets to come up with an Illinois percentage of nearly 1.5 percent, and I took that 1.5 percent and multiplied it by the total proceeds that are on Federal Form 4797 to come up with an amount that should be included in the Illinois sales factor.

Q Where did you obtain your figures?

A The audit numbers?

Q Correct.

A From the taxpayer's source of documents.

Q Is there a particular document that you would have referred to?

A Well, it would have been like their apportionment work sheets they would have supplied and the federal balance sheet, but that's what the top part is, and the receipts from tangible assets, that's from the Federal Form 4797.

Q So you took these numbers right off their federal return?

A Except the Illinois property.

* * *

[203] BY MR. FRANKEL:

Q You don't know the part about their holding the use of funds being—

A Correct, I don't.

Q Would you please turn to your report, which is Defendants' Exhibit A, the page that you were reading from, which was the one on how you computed the alleged taxable gain for Illinois. You called it Illinois portion of gain. Do you have that page in front of you?

A Yes, I do.

[204] Q So what you did was, you used on the top part of your page a property factor which came to 0.014, et cetera?

A Correct.

Q And applied that to assets here in Illinois. And you have some number here. It says Illinois portion of receipts?

A Correct.

Q And then at the bottom of the page, you're taxing the intangibles and you come up with a $40-million gain number by not using a property factor, by using a wages and a sales factor; is that right?

A That's correct.

Q But the wages and the sales factor, which I believe is your 0.03, is about triple the 0.01, isn't it?

A Yes, that number is higher than the asset amount, correct.

Q So this adjustment is driven by your proposed taxation of the intangibles; is that right?

A What I was trying to do was to use—

Q It's a yes or no question. Is this adjustment driven by your trying to tax for Illinois [205] all these intangibles? It's a yes or no.

A Yes, the portion—

Q Thank you. Were you aware before today that MDC had six buildings in Ohio, Lexis-Nexis?

A I knew they had two large buildings in Ohio. I didn't know there were six.

Q Were you aware that's where they did all their development of their database and all their technical work?

A Yes.

Q Were you aware that that's where all the intangibles were that were worked on, there in Ohio, did you know that?

A No.

Q You didn't know that. Okay.

You testified that you do about 40 audits a year?

A Yes.

Q And there's about 8 business/nonbusiness issues you have a year?

A That's correct.

Q For how many years, roughly?

A Oh, for the audit period?

[DEFENDANT'S TRIAL EXHIBIT A—EXCERPT]

The Mead Corp.
Illinois sales of MCD disposal

Sch X1-B
xx-xxxxxxx
6/6/97
FAM

		12/31/93	
Illinois Property		4,406,947	
MDC Assets		341,843,038	
Capital leases		-29,610,839	
Land		-1,148,635	
		311,083,564	
Illinois Percentage		0.014166	
			12/31/94
Receipts from tangible assets			126,455,018
IL. portion of receipts			1,791,418
MDC	12/31/93		
Illinois wages	4,095,601		
Everywhere wages	189,352,719		
Illinois Percentage		0.021629	
Illinois sales	40,757,730		
Everywhere sales	534,770,828		
Illinois Percentage		0.076215	
Total IL percentage		0.112011	
Average		0.037337	
Gain from sales of intangibles			1,089,499,541
Illinois portion of gain			40,678,732

73 53072a 64pgp

No. 06-1413

Supreme Court, U.S.
FILED
NOV 5 - 2007
OFFICE OF THE CLERK

In The
Supreme Court of the United States

MEADWESTVACO CORPORATION, SUCCESSOR IN INTEREST TO THE MEAD CORPORATION,

Petitioner,

v.

ILLINOIS DEPARTMENT OF REVENUE, DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE, AND TREASURER OF THE STATE OF ILLINOIS,

Respondents.

On Writ Of Certiorari To The Appellate Court Of Illinois

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QUESTION PRESENTED

Is the attempt by Illinois to tax the approximately $1 billion gain realized by petitioner when it sold its investment in Lexis/Nexis in 1994 (which it acquired in 1968 for $6 million and which functioned for 26 years as an independent, nonunitary business) in direct conflict with the Due Process and Commerce Clauses of the United States Constitution and the decisions of the Court?

PARTIES TO THE PROCEEDING

The parties to the proceeding are listed in the caption.

RULE 29.6 CORPORATE DISCLOSURE STATEMENT

Petitioner MeadWestvaco Corporation is the successor in interest to The Mead Corporation, which was a publicly held company with no parent company or publicly held company owning more than 10 percent of the company's stock during the year ended December 31, 1994, which is the tax period involved in the dispute.

Petitioner MeadWestvaco Corporation was formed as of January 29, 2002. From January 29, 2002 through December 31, 2002, MeadWestvaco Corporation functioned as a holding company with two assets—all of the stock of The Mead Corporation and all of the stock of Westvaco Corporation. On December 19, 2002, MW Custom Papers, Inc. was incorporated. On December 31, 2002, The Mead Corporation was merged into MW Custom Papers, Inc. Later on December 31, 2002, MW Custom Papers, Inc. was converted into MW Custom Papers, LLC. After this conversion, the majority of the operations and assets previously owned by The Mead Corporation and then contained within MW Custom Papers, LLC were transferred to MeadWestvaco Corporation. MeadWestvaco Corporation is a publicly held company with no parent company or publicly held company owning more than 10 percent of MeadWestvaco Corporation's stock.

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OPINIONS BELOW

The denial by the Supreme Court of Illinois of the petition for leave to appeal (Pet. App. 41a) is reported at 222 Ill. 2d 609, 862 N.E.2d 235.

The opinion of the Appellate Court of Illinois, First Judicial District, Sixth Division (Pet. App. 1a-22a) is reported at 371 Ill. App. 3d 108, 861 N.E.2d 1131. The order of the Appellate Court of Illinois, First Judicial District, granting the respondents' motion to publish the ruling as a precedential decision is unreported. Pet. App. 23a-24a.

The Memorandum Decision, Judgment and Order of the Circuit Court of Cook County, Illinois is unreported. Pet. App. 28a-40a. The Final Judgment Order of the Circuit Court of Cook County is unreported. Pet. App. 25a-27a.

JURISDICTION

The opinion of the Appellate Court of Illinois, First Judicial District, Sixth Division, was entered on January 12, 2007. The Supreme Court of Illinois denied the petition for leave to appeal on January 24, 2007. Petitioner timely filed its petition for a writ of *certiorari* on April 20, 2007. This Court granted the petition on September 25, 2007. This Court's jurisdiction is invoked under 28 U.S.C. § 1257(a).

CONSTITUTIONAL PROVISIONS INVOLVED

The Commerce Clause of the United States Constitution provides in relevant part: "The Congress shall have Power * * * [t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." U.S. Const. art. I, § 8, cl. 3 (the Commerce Clause).

The Fourteenth Amendment to the United States Constitution provides in relevant part: "No State shall * * * deprive any person of life, liberty, or property, without due process of law." U.S. Const. amend. XIV, § 1 (the Due Process Clause).

INTRODUCTION

The State of Illinois taxed The Mead Corporation, a paper and office supplies business, for the gain that it derived from the sale of Lexis/Nexis, the computerized information retrieval business, despite the fact that Mead is not domiciled in Illinois and Lexis/Nexis served no operational function to Mead.

Illinois's imposition of that tax in such circumstances violated the Due Process and Commerce Clauses of the United States Constitution because Illinois did not have an adequate connection to the sale of the asset to tax that gain. Although Illinois may tax the income that Mead derived from its paper and office supplies business that operated in

Illinois and other States through an apportionment among the various States in which that business operated, Illinois cannot impose a tax on Mead's gain from the sale of an asset that did not have an adequate connection to the operation of that multi-state business.

The decision below discards these well-settled constitutional principles, and creates what would amount to a bright-line rule that States can tax an apportioned share of the gain earned on the sale of a multi-state corporation's business units irrespective of whether that business unit has any minimal connection with the corporation's business that is conducted within the taxing State. This Court has repeatedly rejected such attempts by States to elevate corporate form over constitutional substance. The Constitution looks not to whether the business unit has a connection to the taxpayer, but requires instead that the business unit be connected to the taxpayer's business in the State, through functional integration, centralization of management, economies of scale or by otherwise providing critical operational support to the taxpayer's in-State business, such as through working capital or by ensuring access to key resources.

STATEMENT

A. Statutory And Factual Background

1. The Illinois Tax

The State of Illinois determines how much of the income of a corporation that operates in multiple States it can tax by looking to the form of the income of the corporation. Section 1501 of the Illinois Compiled Statutes distinguishes between two forms of income for this purpose, and each is subject to different methods of taxation: "business income" and "nonbusiness income."

During the relevant period, "business income" under Illinois law was defined as income that arises "from transactions and activity in the regular course of the taxpayer's trade or business." 35 Ill. Comp. Stat. Ann. 5/1501(a)(1) (West 1994). Business income "include[d] income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." *Ibid.* Such business income of a multi-state business was taxed by Illinois according to the portion of that business that can be apportioned to Illinois as opposed to the other States in which the business operates. That portion is determined through a state law formula that calculates "Illinois property in proportion to all property" of the multi-state business; "Illinois payroll in proportion to all payroll" of the multi-state business; and "Illinois sales in proportion to all sales" of the multi-state business. Pet. App. 8a;

see also 35 Ill. Comp. Stat. Ann. 5/304(a) (West 1994). In tax terminology, such business income is "apportionable" according to the formula among all the States in which the multi-state business is subject to taxation, and each State can tax its apportioned share.

By contrast, "nonbusiness income" is defined by Illinois to "mean[ ] all income other than business income or compensation." 35 Ill. Comp. Stat. Ann. 5/1501(a)(13) (West 1994). Illinois does not subject that income to apportionment; rather, if such income is taxable in Illinois, the State taxes that income in its entirety as if it is subject to taxation only in Illinois. In tax parlance, this nonbusiness income is "allocated" to that one State.[1]

---

[1] The Illinois statutory provisions are derived from the Uniform Division of Income for Tax Purposes Act (UDITPA). Illinois, like most of its sister States, has enacted a modified version of UDITPA. Each jurisdiction has placed its own construction on UDITPA, either by legislative amendment, regulation, or judicial construction. *See* Jerome Hellerstein, Walter Hellerstein & Joan Youngman, *State and Local Taxation* 605-606 (8th ed. 2005). Accordingly, the rule articulated in one jurisdiction does not necessarily apply to all the other States that have enacted UDITPA in some form. *Id.* And this Court has long recognized that state taxation under UDITPA and state taxation that is *constitutionally* permissible are not coextensive. *See Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 786-787 (1992) (declining to adopt UDITPA as the constitutional test). Indeed, in recognition that its tax scheme and the Constitution were not coextensive, in 2003 Illinois amended its definition of business income, and now defines it as "all income that may be treated as apportionable business income under the

(Continued on following page)

Under this scheme, if a multi-state corporation that is not domiciled in Illinois derives income from the sale of an asset which is an *integral* part of a regular trade or business that it operates, that income can be apportioned amongst the several States in which that business is conducted and which may tax its portion of the business. If, however, that multi-state corporation derives a gain from the sale of an asset that is an investment that is *not* part of its regular trade or business, then that gain is nonbusiness income that is not apportioned among other States for taxation but is taxed only by the corporation's commercial domicile (or site of the investment if it is real property).

2. The Mead Corporation's Investment In Lexis/Nexis

The issue before this Court involves Illinois's taxation of The Mead Corporation (predecessor to petitioner MeadWestvaco Corporation), a multi-state corporation, for a portion of the gain that it derived from its sale of Lexis/Nexis in 1994.

The Mead Corporation was incorporated under the laws of Ohio. It was headquartered in Dayton, Ohio and maintained its commercial domicile there. J.A. 5. The Mead Corporation was (and its successor MeadWestvaco is) engaged in the production and

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Constitution of the United States." 35 Ill. Comp. Stat. Ann. 5/1501(a)(1) (West 2003).

sale of forest products, including paper, packaging and paperboard, and office and school supplies. J.A. 9.

a. Acquisition and growth of Lexis/Nexis. The Mead Corporation acquired Data Corporation in 1968 for $6 million. *Ibid.* Mead was interested primarily in Data Corporation for its ink-jet printing technology, which related to Mead's paper and office supplies business. Data Corporation also happened to possess reconnaissance technology and a full-text information retrieval technology, which later was developed into Lexis/Nexis. J.A. 152-153 (Testimony of James P. Roemer ("Roemer Testimony")).

Shortly after The Mead Corporation acquired Data Corporation, the information retrieval technology part of Data Corporation was transferred to an entity separate from The Mead Corporation, which was designated Mead Data Central. J.A. 9. Between 1968 and 1972, Mead Data Central worked with bar associations in Ohio and Missouri to develop its full-text information retrieval technology into a service that would assist in researching the law. The Mead Corporation provided some investment capital to sustain these efforts, J.A. 169 (Roemer Testimony), but The Mead Corporation, itself, continued to focus on its paper and office supplies business.

By 1973, Mead Data Central became known as Lexis and was launched as a legal information retrieval technology service on a nationwide basis. J.A. 153 (Roemer Testimony). In 1975, Lexis reached

a critical turning point because most courts, and then most law firms, had become its customers. J.A. 154 (Roemer Testimony). Nexis, a news and information service aimed at the financial market, was launched a few years later, and the service then became known as Lexis/Nexis. J.A. 9. Within a decade, Lexis/Nexis had grown from a small legal database into the world's premier provider of online legal research information and the pioneer of computer-assisted news retrieval. *Ibid.*

b. The separate operations of The Mead Corporation's paper and office supplies business and the Lexis/Nexis online research business. The Mead Corporation engaged in no daily oversight of Lexis/Nexis. Instead, Lexis/Nexis's separate online information retrieval business developed its own computer technology culture, practices, and business plans, which ultimately helped foster that investment's substantial growth and success. J.A. 162, 166-167 (Roemer Testimony), 174 (Testimony of James M. McGrane ("McGrane Testimony")). The involvement of The Mead Corporation's board of directors with Lexis/Nexis was limited to consultation about the hiring of only its most senior corporate executives, major capital expenditures, changes to Lexis/Nexis's legal structure and other large, nonrecurring transactions. J.A. 13, 15.[2]

---

[2] Lexis/Nexis merged into and became a division of Mead in 1980. In 1985, Lexis/Nexis was reincorporated as a separate

(Continued on following page)

Lexis/Nexis and The Mead Corporation maintained separate brand names and separate bank accounts. J.A. 10.[3] There were no transfers of sales or accounts receivables between the two companies. J.A. 11.[4]

Mead had separate headquarters from Lexis/Nexis, as well as separate manufacturing, sales, and distribution facilities. J.A. 12-13. Lexis/Nexis maintained its own full-time management to control its day-to-day operations and maintained its own departments, including: accounting, internal auditing, credit and collections, human resources,

---

subsidiary of Mead. J.A. 164 (Roemer Testimony). In 1993, Lexis/Nexis again merged into and became a division of Mead. Tax savings were considered in both of the mergers. J.A. 14. The change in the legal relationship between Mead and Lexis/Nexis did not in any manner affect the operations of Lexis/Nexis. J.A. 165 (Roemer Testimony), J.A. 176-177 (Testimony of Timothy R. McLevish ("McLevish Testimony")).

[3] Although the Mead name appeared in some Lexis/Nexis advertising, it was never prominent; "LEXIS/NEXIS" was the brand name of the computerized information retrieval service and was the name by which the company was known to its customers. J.A. 171 (McGrane Testimony). Indeed, although Lexis/Nexis employees had Mead business cards that they used when they were with Mead executives, they also had Lexis/Nexis cards which they used the majority of the time because it was the Lexis/Nexis name that was recognized in the industry. J.A. 162-163 (Roemer Testimony).

[4] On occasion, Mead invested Lexis/Nexis's own excess funds, but those funds, and the investment returns on those funds, accrued specifically to Lexis/Nexis. J.A. 180-182 (McLevish Testimony).

real estate management, purchasing, and marketing. Even the functions that could have been shared by these divergent businesses—such as security, in-house and outside legal counsel, and employee benefits packages—were kept distinct from one another. J.A. 10-13. Mead's customers received no discount if they were also Lexis/Nexis customers, and Lexis/Nexis' customers likewise did not receive any discount if they were also Mead customers. J.A. 163-164 (Roemer Testimony).

Indeed, even Mead, itself, was billed as a regular customer by Lexis/Nexis, and paid as such, for the Lexis/Nexis services it used. J.A. 164 (Roemer Testimony). And Mead, in turn, did not offer any discount to Lexis/Nexis for the paper that Lexis/Nexis used. In fact, Lexis/Nexis primarily purchased its paper from *other* sources. J.A. 168 (Roemer Testimony).

*c. **Mead's sale of Lexis/Nexis.*** On May 16, 1994, The Mead Corporation announced its intent to sell Lexis/Nexis, J.A. 14, and completed that sale for approximately $1.5 billion on December 2, 1994. *Ibid.* The Mead Corporation and its successor have had no further investment or interest in any electronic publishing or online information retrieval business. *Ibid.*

Mead used the gain on its sale of Lexis/Nexis for a stock repurchase program ($349,664,065), to retire debt ($725,550,000), to pay taxes ($424,700,000), and for other purposes ($85,935). J.A. 14-15. Mead

repurchased the shares of stock and paid off outstanding debt in order to maximize the value of its stock for its shareholders and to minimize its vulnerability to a corporate takeover. J.A. 15.

B. Proceedings Below

1. After The Mead Corporation sold Lexis/Nexis, the State of Illinois issued two notices of tax deficiency to Mead asserting, among other issues not relevant to the case now before this Court, that The Mead Corporation was required to apportion its gain from its sale of Lexis/Nexis to Illinois so that Illinois could tax The Mead Corporation for a share of Mead's gain on the sale.

Mead paid that Illinois tax under protest, Pet. App. 5a, and then brought the instant suit for a refund in the Circuit Court of Cook County, asserting that Illinois lacked a sufficient constitutional nexus to Mead's investment in Lexis/Nexis to tax any part of Mead's gain from its sale of Lexis/Nexis.

The Cook County court ruled that Mead is a distinct business from the Lexis/Nexis computerized online information retrieval service business, and thus the two businesses are *not* one unitary business for tax purposes. *Id.* at 35a-39a. The court held that the two businesses "were not functionally integrated, there was no centralization of management and no significant economies of scale between the two businesses." *Id.* at 39a. Rather, the court found that the two businesses maintained separate departments,

resources, and procedures, and that the only manner in which there was *any* integration was the "extraordinary purchases requiring capital investment and the interest rate advantage gained by Mead through the nightly sweep of bank accounts" which was "not sufficient evidence that the two were functionally integrated." *Id.* at 35a. Moreover, this "approval of extraordinary purchases and considering the operations of Lexis/Nexis in its own strategic planning" was "not centralized management." *Id.* at 36a. No economies of scale were realized because "neither company enjoyed nor was offered a discount nor was required to purchase the products or services of the other" and the "testimony was that Lexis/Nexis often bought paper from other vendors." *Ibid.*

The trial court also noted that the fact that the two different businesses had filed, under protest, a tax return as a unitary business at the directive of the Illinois Department of Revenue did not change that fact. *Id.* at 38a. The court relied on a stipulated record from the parties, as well as on extensive expert testimony.[5]

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[5] Two tax expert witnesses and one expert witness in economics testified and submitted reports detailing their findings. Pet. App. 71a (tax expert Richard D. Pomp testified that no operational relationship existed between Mead and Lexis/Nexis); Pet. App. 57a (tax expert Walter Hellerstein testified that the relationship between the two businesses "involved no meaningful functional integration, centralized management, or economics of scale" and that neither asset "served an operational function in each other's business"); Pet.

(Continued on following page)

Because the two businesses are not a unitary business, the mere fact that The Mead Corporation operated in Illinois did not give Illinois the right to tax Mead on its gain from its sale of Lexis/Nexis. Rather, Illinois was entitled to tax Mead on that gain only if the capital transaction served an "operational function" to Mead, in which case the gain would be apportionable among the States in which that business was conducted, including Illinois which could then tax Mead on its apportioned share.

The Mead Corporation contended that neither the investment in Lexis/Nexis nor its sale served an operational function in Mead's business of selling paper and office supplies, but instead served only as a passive investment. The trial court, however, rejected that argument. The trial court ruled that "Mead's investment in Lexis/Nexis" served "an operational purpose," based on the lone observation that "Lexis/Nexis represented a significant business segment of Mead" that Mead had the power to "expand or contract" the Lexis/Nexis business. Pet. App. 38a-39a.

App. 93a (economics expert Ferdinand P. Schoettle concluding that there was "virtually zero" operational integration between Mead and Lexis/Nexis and that Lexis/Nexis was a " 'stand alone' company"). These expert reports are reprinted in the appendix to the petition. Pet. App. 48a-58a (Hellerstein report); Pet. App. 59a-77a (Pomp report); Pet. App. 78a-103a (Schoettle report).

2. The Appellate Court of Illinois, First Judicial District, affirmed. Pet. App. 1a-24a.

The court recognized that the facts "are essentially undisputed." Pet. App. 2a. The court ruled that Mead's gain on its sale of Lexis/Nexis was apportionable by Illinois for its taxation of a share of the gain because Mead's investment in Lexis/Nexis served an operational function for Mead.[6] Pet. App. 11a. The court did not, however, explain how Lexis/Nexis or its sale contributed to the operational function of Mead's unitary paper and office supplies business. Instead, the court cited Mead's 100 percent ownership interest in Lexis/Nexis, its contributions to Lexis/Nexis's capital, and its description of the Lexis/Nexis business in its annual reports and Forms 10-K. Pet. App. 12a-13a. The court rejected Mead's constitutional challenge to imposition of the tax. *Id.* at 17a-18a.

The court granted Illinois' motion that the decision be published as a precedential decision. Pet. App. 42a-47a.

3. The Supreme Court of Illinois denied review. Pet. App. 41a.

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[6] The Appellate Court of Illinois did "not address the Department's claim of error as to the [Circuit Court's] 'lack of unitary business' finding." Pet. App. 11a.

SUMMARY OF ARGUMENT

I.

A. The Commerce and Due Process Clauses of the United States Constitution prohibit a State from taxing activity that occurs, or value that is earned, outside its borders. In the case of a corporation that conducts its business in multiple States, a State in which the corporation is not domiciled must measure the amount of the multi-state corporation's income that it can tax based on the contribution that the corporation's activity in that State makes to the multi-state business.

States in which multi-state corporations operate have used various methods to measure what portion of a multi-state corporation's income they can tax. A straightforward approach is geographical or transaction accounting, which relies on where the activity occurs, but that may not fully reflect the in-State contribution to the overall business by ignoring unquantifiable value that is earned by the business but which is not readily associated with a particular State or States. Therefore, States often tax an apportioned share of a multi-state corporation's total income in an attempt to capture value that the geographical or transaction approach would miss.

The Court has approved of such state tax apportionment in two circumstances. First, the Court has upheld as constitutional a State's taxation of a multi-state corporation for a portion of its total income derived from its "unitary business" when the

State apportions to the State a share of that total income that reflects the in-State contributions to that income. Second, the Court has sustained a State's tax of a multi-state corporation for the gain associated with a nonunitary asset or investment where that asset or investment nonetheless served an integral "operational function" for the corporation's unitary business, and was not a mere return on its invested capital.

B. The Mead Corporation's gain on the sale of Lexis/Nexis is the paradigmatic example of a gain that cannot be constitutionally taxed by a State based merely on the fact that Mead operated in that State. Because Lexis/Nexis's computerized electronic data retrieval business was not unitary with Mead's business (*i.e.*, manufacturing and selling paper and office supplies), the only constitutional basis on which Illinois could tax Mead's gain on the sale of Lexis/Nexis would be if Lexis/Nexis served an operational function in Mead's unitary business, but it did not.

A nonunitary asset of a business serves an operational function in that business only if the asset provides ongoing (as opposed to occasional) support to critical aspects of the business, which was not so here. Mead's ownership of Lexis/Nexis was a long-term, passive investment that was, for 26 years, maintained separate and distinct from the business of manufacturing paper and office supplies. Mead did not use Lexis/Nexis as a source of working capital or

to support its paper and office supplies business in any other way.

The fact that Mead monitored Lexis/Nexis's performance, as any prudent investor would do, does not transform the investment into an operational asset that sustained Mead's business. This Court recognized in *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), that in order to "convert an otherwise passive investment into an integral operational one," *id.* at 788, it is not enough that the investment was "'acquired, managed or disposed of for purposes relating or contributing to the taxpayer's business,'" *id.* at 789 (quoting *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 326 (1982)). Otherwise, all of a corporation's investments would always satisfy the operational function test because they always in some way relate or contribute to the corporation's business. Accordingly, the court below wholly ignored the requirement that the investment be used or designed to sustain and support Mead's business when the court relied, instead, on the fact that Mead derived economic benefit from its ownership in and sale of Lexis/Nexis.

The court's reliance upon Mead's ownership of Lexis/Nexis, its minor oversight over and capital investment in the asset, and its description of the asset's business in Mead's annual reports and Forms 10-K bear no relation to the operational function test. That test looks for a significant nexus between the investment and the taxable *activities* in the State,

and not a mere connection to the taxable *business*. Indeed, if these factors were relevant at all (and this Court's precedents say otherwise), they could inform only whether Lexis/Nexis was part of Mead's unitary business, an argument rejected below.

II.

The Illinois appellate court's decision eviscerates the federal constitutional limits on state taxation. Under the decision of the court below, all gain earned by a multi-state corporation from any wholly-owned subsidiary or division—even where that subsidiary or division lacks any relationship with the parent's regular business which is conducted in multiple States—is taxable by all of those States on an apportioned basis. This is so because each of the factors that the state court viewed as dispositive in this case is present in every relationship with a corporate parent and its business units, even if there is no unitary relationship between them.

A. Illinois's argument that there is a flow of value between Mead and Lexis/Nexis that justifies its taxation of Mead on the gain from the sale of Lexis/Nexis is based upon a misreading of this Court's precedents. A "flow of value" between a taxpayer parent and its subsidiary or division is relevant to whether there is a unitary relationship and not to whether the asset or its disposition served an operational function, and it is not satisfied by a mere occasional flow of funds or other benefits.

Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 166 (1983). Otherwise, a State's taxation of a parent on an apportioned share of all of the income of all of the parents' wholly-owned subsidiaries or divisions would nearly always be constitutionally permissible.

Indeed, Illinois's position that it need *not* demonstrate that the Lexis/Nexis electronic, online research business was used *at all* to benefit Mead's paper and office supplies business is contrary to this Court's requirement that there be a connection between the taxing State and the taxed conduct. More than a century of this Court's precedents have required a relationship between the income being taxed and the business's activities in the taxing State.

B. The Illinois appellate court's holding that a corporation's ownership of a business is the critical factor to determine whether that corporation's gain from the sale of the business is apportionable among the many States in which the corporation operates would lead to severe misattribution of income. The rule would upset well-established apportionment principles upon which both corporations and state taxing authorities rely. It would strip Illinois's sister States of legitimate claims to a portion of their tax base.

III.

The Illinois appellate court's decision threatens to subject multi-state corporations to unconstitutional multiple taxation. The Constitution precludes a State from overreaching into the portion of the tax base that belongs to a sister State, because doing so creates the threat of multiple taxation and thus burdens interstate commerce. By imposing a tax on The Mead Corporation's gain of its investment in Lexis/Nexis, Illinois overreached into a tax base that belongs of right to Ohio. Because Ohio has the constitutional claim to tax the entirety of Mead's gain at issue here, Illinois's taxation of an apportioned share creates a substantial threat of unconstitutional duplicative taxation.

ARGUMENT

I. THE CONSTITUTION PROHIBITS ILLINOIS FROM TAXING THE MEAD CORPORATION ON ITS SALE OF LEXIS/NEXIS BECAUSE THAT GAIN OCCURRED OUTSIDE ILLINOIS AND THAT ASSET WAS UNRELATED TO MEAD'S BUSINESS OF PAPER AND OFFICE SUPPLIES

The Commerce and Due Process Clauses prohibit a State from taxing a gain earned outside its borders. *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 777 (1992).

Illinois taxed The Mead Corporation, a nondomiciliary company, on its gain on the sale of its investment in Lexis/Nexis. But the sale was a capital

transaction that occurred outside the borders of Illinois, and Mead's ownership of Lexis/Nexis—the electronic, online research business—bore no relation to and was not integrated with Mead's paper and office supplies business that operated in Illinois and other States.

Accordingly, Illinois lacked the requisite constitutional nexus to tax an apportioned share of that gain. Illinois's tax on The Mead Corporation for its gain from its sale of its investment in an electronic, online research business that was distinct from Mead's paper and office supplies business crossed the line to unconstitutional taxation.

A. The Commerce And Due Process Clauses Require That A State Possess A Concrete Connection To Activities That It Taxes

1. A State can tax only the in-State value of a multi-state business

States have long struggled over how to maximize their taxes on multi-state corporations in a manner that comports with the Commerce and Due Process Clauses.

The Commerce Clause prohibits States from imposing extraterritorial taxes because of the "drastic consequences for the national economy, as businesses could be subjected to severe multiple taxation" by the multiple States in which the businesses operate. *Allied-Signal*, 504 U.S. at 777-778. The Due Process

Clause requires that a State possess a "minimal connection" to a multi-state activity of a nondomiciliary business that it taxes and a rational relationship between the portion of such activity on which the State imposes the tax (*i.e.*, the amount apportioned to the State), and the interstate value of the multi-state business's activity. *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 272-273 (1978). This means "that, in the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection to the actor the State seeks to tax." *Allied-Signal*, 504 U.S. at 778 (citing *Quill Corp. v. North Dakota*, 504 U.S. 298, 306-308 (1992)).

Because of these constitutional limitations, States must measure, and can tax *only*, the in-State contribution to a multi-state corporation's income. This Court has recognized that such measurement of in-State contribution to the "value" of a "more-or-less integrated business enterprise operating in more than one State" can be "an elusive goal, both in theory and in practice." *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 164 (1983).

States have taken different approaches to measuring the value added to a multi-state business within their borders in order to maximize their tax revenue. Geographical or transactional accounting provides one method for States to identify locally taxable income. Such accounting isolates portions of income received within the borders of various States by a multi-state corporation. *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 438

(1980). This accounting and taxation may, however, undercalculate the tax base by "ignor[ing] or captur[ing] inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise." *Container Corp.*, 463 U.S. at 164-165; *see also Mobil Oil*, 445 U.S. at 437 (noting that such method "may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale").[7]

Efforts by the States to capture the value that may be missed by geographic and transactional accounting date back to the early era of railroads and telegraphs when the States first "encountered the difficulty that what makes such a business valuable is the enterprise as a whole, rather than the track or wires that happen to be located within a State's borders." *Allied-Signal*, 504 U.S. at 778. This Court held then that the Constitution thus permits "a State [to] base its tax assessments upon 'the proportionate

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[7] That geographical and transactional accounting may sometimes be underinclusive does not render its application as unconstitutional because a State may adopt a method of taxation that does not realize all constitutionally permissible taxes. *See Container Corp.*, 463 U.S. at 167-168 (noting that "a State might decide to respect formal corporate lines and treat the ownership of a corporate subsidiary as *per se* a passive investment" even though that "is not constitutionally required"). The fact that one State may decide to tax *less* than what is constitutionally permissible does not provide other States with the latitude to tax more than their own in-State contributions to the entire enterprise.

part of the value resulting from the combination of the means by which the business was carried on, a value existing to an appreciable extent throughout the entire domain of operation.'" *Id.* at 778-779 (quoting *Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194, 220-221 (1897)). As such, where a multi-state corporation's income is derived from a "series of transactions" (from manufacturing to sale) that cross the territorial borders of multiple jurisdictions, a State can tax an apportioned share of the multi-state company's total income that reflects the value that was fairly attributable to "the processes," rather than just the receipts, "conducted within its borders." *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 120-121 (1920).

Thus, States now often tax an apportioned share of the total income of a multi-state corporation. This Court has approved such apportionment as a general matter, but also has held that it cannot be used to expand a State's putative tax base beyond constitutionally permissible bounds. *See, e.g.*, *Allied-Signal*, 504 U.S. 768; *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *F. W. Woolworth Co. v. Taxation & Revenue Dep't of the State of New Mexico*, 458 U.S. 354 (1982). For example, in *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931), the Court ruled that a State tax apportionment method based entirely upon ownership of tangible property resulted in an attribution to North Carolina of income that was out of proportion to the taxpayer's business in the State. The Court held that the method, "albeit fair on its

face, operates so as to reach profits which are in no just sense attributable to transactions within its jurisdiction." *Id.* at 134.

The limitations on state taxation of multi-state corporations imposed by the Commerce and Due Process Clauses thus prohibit a State from sweeping into its coffers value that is properly taxed only by its sister States. State laws that tax an apportioned share of a multi-state corporation's economic activity are limited by the Constitution to taxing the in-State contributions to the taxed business. *Ibid.*

2. A State may tax an apportioned share of an activity of a multi-state corporation only if that activity is part of the corporation's unitary business that operates in the State or is used to operationally support that unitary business

Illinois agrees, as it must, that the apportionment method of state taxation of a multi-state corporation is permissible only in two circumstances—"if the multistate operation is run as a single unitary business or if the asset or transaction a State seeks to tax served an operational function" for the corporation's unitary business operating in the State. Br. in Opp. at 7. Indeed, this Court has repeatedly held that "the *linchpin* of apportionability in the field of state income taxation is the unitary-business principle." *Mobil Oil*, 445 U.S. at 439 (emphasis added). The operational function test, by contrast, constitutes a narrow *exception* that permits a State to tax

an apportioned share of income or gain from an asset or investment that is *not* part of the unitary business if, for example, the asset "forms part of the working capital of the corporation's unitary business." *Allied-Signal*, 504 U.S. at 787.

Both circumstances where a State may tax an apportioned share of a multi-state business's income or other economic gain are based upon the same rationale. The unitary business principle and the operational function test seek to capture the "subtle and largely unquantifiable" in-State contributions to the overall value of a multi-state business. *Container Corp.*, 463 U.S. at 164-165; *see also Allied-Signal*, 504 U.S. at 783. Apportionment is permissible under the unitary business principle only where several businesses, as part of common ownership or as different parts of the same business, are so functionally dependent upon each other that the value of the whole is greater than the sum of its parts. Apportionment of the value of the whole then provides a more accurate measure of the in-State contribution to that business that an individual State may tax than just the taxation of a particular segment of the business in that State.

This Court has explained that a State calculates the in-State contribution to a business "by first defining the scope of the 'unitary business' of which the taxed enterprise's activities in the taxing jurisdiction form one part." *Container Corp.*, 463 U.S. at 165. Then the State "apportion[s] the total income of that 'unitary business' between the taxing

jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the jurisdiction." *Ibid.*; *see also Mobil Oil*, 445 U.S. at 437 (a State can tax an apportioned share of the income of a multi-state corporation "so long as the intrastate and extrastate activities formed part of a single unitary business").

And where a multi-state corporation receives income or gain from an asset or investment that is separate from the corporation's unitary business conducted in the taxing State, the State may tax an apportioned share of that income or gain only in the limited circumstances allowed by the operational function test. *Allied-Signal*, 504 U.S. at 789. That test allows the State to tax the multi-state corporation only where the asset or investment provided on-going "integral operational" support to the unitary business operating in the taxing State. *Id.* at 788; *ASARCO*, 458 U.S. at 326. That test does not allow a State to tax a multi-state corporation if the income from the asset or investment was just "a return on its invested capital." *ASARCO*, 458 U.S. at 326.

States do *not* have unlimited latitude under the Commerce and Due Process Clauses to tax an apportioned share of the entirety of a multi-state corporation's income or gain merely because the corporation conducts business in the State. The unitary business principle and the operational function test impose a "necessary limit on the States'

authority to tax value or income that cannot in fairness be attributed to the taxpayer's activities within the State." *Allied-Signal*, 504 U.S. at 780; *see also Container Corp.*, 463 U.S. at 166 (requiring that "the out-of-State activities of the purported 'unitary business' be related in some concrete way to the in-State activities").

B. The Mead Corporation's Investment In And Sale Of The Lexis/Nexis Online Research Business Is The Paradigmatic Example Of A Non-Apportionable Gain

The trial court correctly ruled that The Mead Corporation and Lexis/Nexis were not a unitary business. Pet. App. 38a. None of the indicia of a unitary business were present. Illinois entered into a stipulation that established that Mead's business to manufacture and sell paper and office supplies was distinct and separate from the Lexis/Nexis electronic online research business in virtually every way. J.A. 9-16. The two were in completely separate and unrelated lines of business and operated under different brands. J.A. 10. They had separate departments for virtually every corporate function, including among others, human resources, accounting, legal, and marketing. J.A. 10-11. There was no integration between the two businesses, and Lexis/Nexis was run as a completely autonomous business that was not subject to operational oversight by The Mead Corporation. J.A. 13. The two lines of business segregated and kept separate all accounts,

shared no facilities, shared no employees, and made independent employee decisions. J.A. 12-13.

Thus, under this Court's well-settled principle and as the trial court concluded, apportionment to Illinois of a portion of Mead's gain on its Lexis/Nexis sale was not permitted under the "unitary business" principle because the out-of-state event that Illinois sought to tax did not give rise to income that "'result[ed] from functional integration, centralization of management, [or] economies of scale'" of the unitary business conducted in Illinois. *ASARCO*, 458 U.S. at 317 (quoting *Mobil Oil*, 445 U.S. at 438).

The trial court erred, however, when it nonetheless upheld the apportionment to Illinois of a portion of Mead's gain on its Lexis/Nexis sale under the "operational function" test. This Court permits a State to tax an apportioned share of the gain or income from a nonunitary asset or investment under that test only in circumstances where that asset provides a continuing, significant contribution to *support* the unitary business conducted in the State in some substantial, operational capacity. That was not the case here.

1. The Mead Corporation's investment and sale of Lexis/Nexis served no operational function for Mead's paper and office supplies business and thus cannot be taxed by Illinois

Illinois acknowledges (Br. in Opp. 8) that this Court has articulated few circumstances in which income or gain from a nonunitary asset can nonetheless serve an operational function to a unitary business operating within the taxing State, and thus be taxed on an apportioned basis. Those circumstances include where the asset is used to regularly fund the working capital of the unitary business that operates within the taxing State, or where the asset, itself, is designed to support the unitary business with the requisite nexus to the taxing State, such as by providing an on-going stable supply of key resources. *Ibid.* (citing *Allied-Signal*, 504 U.S. at 778). The Court has provided the example of "the interest earned on short-term deposits in a bank located in another State" as an activity that serves an operational function "if that income forms part of the working capital of the corporation's unitary business, notwithstanding the absence of a unitary relationship between the corporation and the bank." *Allied-Signal*, 504 U.S. at 787-788. Likewise, "loans and loan guarantees" that support "operations" in the same lines of work as the unitary business, *Container Corp.*, 463 U.S. at 178, 180 n.19, and gains from hedging against market risk in the commodity futures markets from supply shortages for the

unitary business, *Corn Products Refining Co. v. Commissioner of Internal Revenue*, 350 U.S. 46 (1955), can also satisfy the operational function test.[8] *See also ASARCO*, 458 U.S. at 324 n.21 (noting that nonunitary "stock investments" could have served an operational function had they "been accumulated for the future operation of [ASARCO's] own primary business").

In those circumstances, the operational function test justifies the State taxing the corporation for the income or value from that non-unitary asset or investment when that income or value is used in a regular, on-going operational capacity by the parent's unitary business within the taxing State (such as by funding key segments or functions or by providing a regular supply of certain raw materials), because that income then is *related to* activities carried on in the taxing State. *See Allied-Signal*, 504 U.S. at 787; *see also* Walter Hellerstein, *State Taxation of Corporate Income from Intangibles:* Allied-Signal *and Beyond*, 48 TAX L. REV. 739, 791 (1993).

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[8] In *Container Corp.*, this Court cited *Corn Products Refining* as an example, "in another context," of how "capital transactions can serve either an investment function or an operational function." *Container Corp.*, 463 U.S. at 180 n.19. Although *Container Corp.*, itself, discusses the operational function test, the facts of that case relate to the unitary business, which is the ground on which the case was decided. *See id.* at 178 (noting that the parent and subsidiary were "engage[d] in the same line of work" so that the subsidiary supported the parents "through economies of scale or through operational integration or sharing of expertise").

There is no reason to believe that the sale of a nonunitary asset of the sort at issue here—*i.e.*, where Mead had the ability to control the nonunitary Lexis/Nexis business but did not—could *ever* satisfy the operational function test. *Allied-Signal*, *Woolworth*, and *ASARCO* suggest as much. The Court in *Allied-Signal* explained that to satisfy the operational function test the "capital transaction," itself, must "serve an operational rather than an investment function." *Allied-Signal*, 504 U.S. at 787. And just as the *sale* of Lexis/Nexis—*i.e.*, the capital transaction Illinois seeks to tax—did not serve any operational function to Mead, neither did the sale of stock in *Allied-Signal*, nor the sale of subsidiaries in *Woolworth*, nor the dividends, interest income, or capital gains in *ASARCO*. Indeed, this Court has explained that the capital transactions in *ASARCO* could have been apportionable to the nondomiciliary taxing State *if* the "stock investments there constituted interim use of idle funds accumulated for the future operation of the taxpayer's business." *Allied-Signal*, 504 U.S. at 787 (internal quotations, brackets, and omissions omitted).

Moreover, assuming it were enough that the nonunitary asset served an operational function *even if* its sale did not (something this Court has never before endorsed), Illinois still could not satisfy that standard to justify taxing the sale. In the instant case, the courts below did not make, nor could the record support, the constitutionally required finding that Mead's nonunitary investment in Lexis/Nexis

served an operational function to Mead's business to manufacture and sell paper and office supplies which operated, *inter alia*, in Illinois. *Allied-Signal*, 504 U.S. at 778 ("in the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax").

Mead never used its investment in Lexis/Nexis (or any profits derived from it) as a de-facto account from which to withdraw profits in order to fund the working capital of Mead's unitary business. Ill. C.A. Rec. Vol. 9 at 214. Nor did Mead's investment in Lexis/Nexis otherwise support the unitary business in any other capacity. J.A. 10-13, 164-168, 172-173, 177-179. For example, not only did Lexis/Nexis *not* provide critical on-going financial support to Mead's unitary business, but it also did *not* provide Mead any guarantee of key supplies to that business which manufactures and sells paper and office supplies.

Rather, Mead's ownership of Lexis/Nexis was a long-term passive investment (it had been acquired as part of an acquisition of an ink-jet printing technology, J.A. 152-153), that was maintained separate and distinct from Mead's primary business for 26 years. *See Allied-Signal*, 504 U.S. at 790 (noting that a two-year investment was sufficiently long-term so as to not serve an operational function). Indeed, to the extent there was any contribution between the two businesses that was relied upon by the court below to justify apportionment, the direction in which that contribution flowed—in the

form of occasional capital contributions—went *from* Mead, as an investor, *to* Lexis/Nexis.

2. Mead's action as a prudent investor did not transform its non-operational, passive investment into one that satisfied the operational function test

Illinois ignores the limited scope of the operational function test and argues that its taxing authority extends to a nondomiciliary corporation's out-of-state sale of a nondomiciliary business based solely on the fact that the nondomiciliary corporation, The Mead Corporation, did what any prudent investor may do, *i.e.*, ensure that its investment in Lexis/Nexis was profitable and beneficial to Mead and its shareholders. *See, e.g.*, Pet. App. 13a ("Mead developed Lexis/Nexis by contributing capital support until it became profitable.").

Mead unquestionably kept track of how its Lexis/Nexis investment performed. Basic corporate fiduciary responsibility required as much, for even the most passive investments held by a corporation. *See, e.g.*, 1-1 William E. Knepper & Dan A. Bailey, *Liability of Corporate Officers and Directors* § 1.02 (1969) (stating that reviewing the corporation's investments is among the directors' duties); American Bar Ass'n, *Corporate Director's Guidebook*, 49 BUS. LAW. 1247, 1249 (1994) (listing a director's activities to include "approving fundamental operating, financial, and other corporate plans, strategies and

objectives"). Accordingly, Mead's Board of Directors necessarily had authority with respect to some of the highest level of decisionmaking in Lexis/Nexis, J.A. 15 (approving large capital expenditures), or else they would have abdicated the responsibility that they had to Mead's shareholders, *see Stone v. Ritter*, 911 A.2d 362, 367 (Del. 2006) (a duty of care is imposed on the Board to its shareholders).

But Mead's limited actions as a prudent investor do not convert its nonunitary investment into one that is subject to apportionment for state taxation wherever Mead's paper and office supplies business was conducted. This Court in *Allied-Signal* and *ASARCO* recognized as much. In addressing whether a "long-term corporate strategy" could "convert an otherwise passive investment into an integral operational one," the *Allied-Signal* Court held that it is not enough that the investment was " 'acquired, managed or disposed of for purposes relating or contributing to the taxpayer's business.' " *Allied-Signal*, 504 U.S. at 788 (quoting *ASARCO*, 458 U.S. at 326). "The business of a corporation requires that it earn money to continue operations and to provide a return on investment. Consequently *all* of its operations, including any investment made, in some sense can be said to be for purposes related to or contributing to the [corporation's] business." *Id.* at 789 (quoting *ASARCO*, 458 U.S. at 326) (brackets in original, internal quotations omitted). To allow States to apportion income for state taxation based on no more

than such a showing would make the constitutional limitation "no limitation at all." *Ibid.*[9]

3. The Illinois appellate court relied upon factors that are inapplicable to the operational function determination

The Illinois appellate court reached its clearly erroneous conclusion because it conflated the factors relevant to the unitary business inquiry with the operational functional test. Presumably, in circumstances unquestionably not present here, more substantial evidence of that sort might demonstrate a unitary business relationship. But in the instant case, there was no such showing, and the trial court was correct when it found no unitary business relationship. Accordingly, the fact that Mead received

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[9] Indeed, it is common for a parent corporation to occasionally oversee a subsidiary or division "with respect to capital structure, major debt and dividends," *F. W. Woolworth Co. v. Taxation & Revenue Dep't of the State of New Mexico*, 458 U.S. 354, 369 (1982), but that fact does not alter the operational function analysis. Rather, that demonstrates only that Mead had "the *potential* to operate a company as part of a unitary business," *id.* at 363, which says nothing about whether the investment in Lexis/Nexis served an operational function. *See also* pages 38-40 *infra*.

Moreover, although not relied upon by the courts below, Mead's use of the gain from the sale of Lexis/Nexis is not relevant to the operational function test. *Allied-Signal*, 504 U.S. at 790. Even if it were, however, the gain itself served no operational function, because it was used to repurchase stock, retire debt, and pay taxes. J.A. 14-15.

tax benefits from and directed money to its investment in Lexis/Nexis, approved some of its major debt and capital expenditures, altered the corporate form of Lexis/Nexis on occasion, and included Lexis/Nexis in its annual reports and Forms 10-K, *see* Pet. App. 12a-14a, showed no more than a *connection* between a parent and its business unit, as opposed to the functional integration, centralization of management, and economies of scale that the unitary business principle requires and that Illinois could not satisfy. *ASARCO*, 458 U.S. at 317; *Mobil Oil*, 445 U.S. at 438. Indeed, these factors demonstrated only the obvious—that Mead owned Lexis/Nexis. *See Wallace v. Hines*, 253 U.S. 66, 69-70 (1920); *Woolworth*, 458 U.S. at 363.

The appellate court's use of these factors thus created a diluted unitary business relationship test as a proxy for demonstrating an operational function. Whether considered individually, or collectively, these factors relied upon by the Illinois court fail to show that Lexis/Nexis, a cutting-edge information technology business, served any operational function whatsoever for Mead's traditional paper and office supplies business. *See Allied-Signal*, 504 U.S. at 788-789.[10]

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[10] Indeed, in its motion to publish the state court decision as precedential, Illinois recognized the novel nature of the ruling below. Illinois argued that the decision provided "crucial guidance" by setting forth specific factors, "such as on-going capital support, approval of major capital expenditures, manipulation of business organizations, and retaining benefits

(Continued on following page)

First, the fact that Lexis/Nexis was 100 percent owned by Mead was irrelevant to whether the Lexis/Nexis investment served an operational function to Mead's paper and office supplies business because the wholly-owned nature of the relationship says nothing about the use of the asset or income from it as it relates to in-State activities. This Court in *F. W. Woolworth Co. v. Taxation & Revenue Department of the State of New Mexico*, 458 U.S. 354, 356-357 (1982), recognized that 100 percent ownership is not a relevant consideration, because there Woolworth and its four subsidiaries were not part of a unitary business even though three of those subsidiaries were wholly owned by Woolworth.

Second, Mead's occasional participation in the direction of its Lexis/Nexis investment, which included changing Lexis/Nexis from a division to a corporate subsidiary and back to a division again, Pet. App. 13a,[11] showed at most only limited control

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and control of excess cash" as relevant to when a "business unit qualifies as an operational asset." Pet. App. 45a. The State, in particular, found significant the fact that the appellate court "approved of specific evidence on which the [State] and courts can rely in making this determination—such as annual reports and federal 10-K statements." *Ibid.*

[11] This Court has explained that it is of no moment that Lexis/Nexis was a division rather than a subsidiary, or vice versa. "[T]he form of business organization may have nothing to do with the underlying unity or diversity of business enterprise." *See Mobil Oil*, 445 U.S. at 440; *see also Edison California Stores v. McColgan*, 183 P.2d 16, 21 (Cal. 1947) (explaining that "no difference in principle is discernable" when discussing the

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and does not demonstrate that that control led to Mead's use of that nonunitary Lexis/Nexis asset in a manner that served an operational function that was critical or important to Mead's business. Indeed, even under the unitary business analysis, such "occasional oversight," or even the *power* to operate a subsidiary or division as part of a unitary business, is insufficient to justify the apportionment of income by a non-domiciliary State. *Woolworth*, 458 U.S. at 369 ("Except for the type of occasional oversight—with respect to capital structure, major debt, and dividends—that any parent gives to an investment in a subsidiary, there is little or no integration of the business activities or centralization of the management * * *."); *see also id.* at 362 ("the *potential* to operate a company as part of a unitary business is not dispositive when, looking at the underlying economic realities of a unitary business, the dividend income from the subsidiaries *in fact* is [derived] from unrelated business activity which constitutes a discrete business enterprise") (emphasis in original) (citations and internal quotations omitted).

It would be irrational to afford such occasional oversight greater significance under the operational function test. Indeed, the Court's ruling in *Woolworth* makes this clear because, of course, when a business is 100 percent owned by another, the owner will have

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difference in corporate form between a subsidiary and a division).

the right to change the form of the business, and the right to any tax advantages resulting from that change in form of the business. But that ownership does not demonstrate an operational function, and the factors that necessarily follow therefrom therefore do not do so either.

Third, Mead's capital investment in Lexis/Nexis as well as the fact that Mead ensured that Lexis/Nexis's excess cash was invested back *into* Lexis/Nexis was not proof that Lexis/Nexis—the electronic, online research business—served an operational function for Mead—the paper and office supplies business. As discussed above, *see* pages 34-35 *supra*, corporations are required to care for their investments, and that fact alone does not give a State the authority to tax an apportioned share of the sale of any wholly-owned subsidiary or division by any corporation that has a business operating in the State. Indeed, under the ruling below, all such gain, "irrespective of whether it is generated by a 'discrete business enterprise,'—would become part of a unitary business if the test were whether the corporation commingled dividends from other corporations, whether subsidiaries or not." *Woolworth*, 458 U.S. at 364 n.11 (citation omitted).

Fourth, Mead's description of the Lexis/Nexis business in its annual reports and Forms 10-K is erroneously viewed by the State (and the court below) as nearly dispositive of Illinois's right to tax an apportioned share of Mead's gain on the Lexis/Nexis sale. Pet. App. 36a-37a. But this Court "focuses on the

objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State" and not on the manner in which the company listed its "profits entry on a financial statement." *Allied-Signal*, 504 U.S. at 785; *see also Woolworth*, 458 U.S. at 369 n.22 (consolidated accounting and consolidated statements do not lead to a conclusion that there existed a unitary relationship).

In sum, Illinois cannot overcome the absence of any evidence that Mead's ownership of Lexis/Nexis provided an on-going significant contribution to sustain and support Mead in a critical operational capacity. And the Illinois appellate court's reliance on the fact that Mead owned and benefited from Lexis/Nexis ignores this Court's repeated "demand" that States demonstrate "more" because a business "derives some economic benefit—as it virtually always will—from its ownership of stock in another corporation." *Woolworth*, 458 U.S. at 364; *see also Wallace*, 253 U.S. at 69-70.

II. ILLINOIS'S VIEWS WOULD EVISCERATE THE CONSTITUTIONAL LIMITS ON STATE TAXATION OF MULTI-STATE CORPORATIONS' EXTRATERRITORIAL INCOME AND GAINS

The Illinois appellate court's decision constitutes a radical departure as to how a corporation's income and gains from wholly-owned subsidiaries or divisions can be constitutionally taxed. By focusing on the fact that

Lexis/Nexis was owned by The Mead Corporation, without examining Lexis/Nexis's connection to Mead's paper and office supplies business, the decision below effectively requires that all income or gains from a wholly-owned subsidiary or division be taxable at the parent on an apportioned basis. This would be the case *even if* (as here) the division itself had no relationship to the parent company's unitary business being conducted within the taxing State.

Indeed, the justifications of the court below for permitting Illinois to tax a nondomiciliary parent on a share of the gain from a nonunitary investment are present whenever a parent corporation acquires a wholly-owned business or subsidiary. *See Woolworth*, 458 U.S. at 363. But the mere existence of such a relationship cannot make all income or gain earned by that parent from that separate business taxable on an apportionable basis. Nor can the other criteria relied upon by the court below be dispositive as to whether a State can tax an apportioned share of such a subsidiary or division. There is always the potential (and occasional) control over the activities of a subsidiary or division, some investment in and some benefit received from the subsidiary or division, and some characterization of the subsidiary's or division's business as it relates to the parent company's business as a whole. *See* pages 34-35 *supra*. But those factors alone do not justify state taxation of the parent corporation. *ASARCO*, 458 U.S. at 326 ("The business of a corporation requires that it earn money

to continue operations and to provide a return on its invested capital.").

A. Illinois Proposes Rules In Which There Are Virtually No Limits On A State's Power To Tax Multi-State Corporations

Focusing on factors that pertain to the existence of a unitary business relationship—the purported flow of some value between The Mead Corporation and Lexis/Nexis and the minimal corporate connections that *must* exist between the two—Illinois proposes a standard that would make taxation on an apportioned share of all of a parent's subsidiaries or divisions constitutionally permissible in virtually all circumstances.

1. Illinois argues that "the focus of the apportionment inquiry remains the flow of value between the business units and management's role in the business unit's affairs," Br. in Opp. at 9, and insists that Mead's investment in Lexis/Nexis satisfies that standard.

But that argument pertains to whether there is a unitary business relationship and, in any event, reads this Court's decisions too broadly. Illinois's construction of these principles would allow a State to tax a nondomiciliary corporation on virtually all income or other gain from its subsidiaries or divisions regardless of any connection to the corporation's business operating in the taxing State. As discussed above (pages 38-40 *supra*), focusing on the "managerial role" played in the business unit's affairs

says nothing about whether an asset or its sale served an operational function to the taxable in-State business. It goes to whether the asset and in-State business are part of a unitary business relationship. *See, e.g.*, *Woolworth*, 458 U.S. at 369-370 (analyzing the taxpayer's management role of its subsidiaries in determining whether the subsidiaries were part of the taxpayer's unitary business); *see also Container Corp.*, 463 U.S. at 180 n.19 ("We made clear in *F. W. Woolworth Co.* that a unitary business finding could not be based merely on the type of occasional oversight * * * that any parent gives to an investment subsidiary.") (internal quotations and citations omitted).

Moreover, this Court has cautioned that the mere flow of some benefits between two business units does not permit virtually *all* investments to be subject to taxation on an apportioned basis under either the unitary business principle or the operational function test, and Illinois and the state court were wrong to suggest otherwise. Rather, a contribution or transfer of value is a necessary but not always sufficient prerequisite for a State to tax an apportioned share of a subsidiary or division. *Allied-Signal*, 504 U.S. at 783. What is required is "some sharing or exchange of value not capable of precise identification or measurement—*beyond the mere flow of funds* arising out of a passive investment or a distinct business operation—which renders formula apportionment a reasonable method of taxation." *Container Corp.*, 463 U.S. at 166 (emphasis added). The fact that the sale

of an asset "adds to the riches" or provides a "business advantage" to a multi-state corporation such as Mead is not enough, *Wallace*, 253 U.S. at 69-70; *Woolworth*, 458 U.S. at 363, because that would be true of any economic activity that produces value, which says nothing as to whether the asset had anything to do with the activities of Mead's unitary business in Illinois. *ASARCO*, 458 U.S. at 329-330.

2. Illinois maintains that a putative taxing State has no obligation to show that "the asset was utilized directly in the selling company's business." Br. in Opp. 8-9. But by eliminating that requirement, as Illinois suggests, a State need not show *any* nexus between the nonunitary asset and the taxable conduct within the taxing State. Rather, under Illinois's rule, *any* connection between the asset and the actor, *viz.*, the unitary business, is enough.

This Court has repeatedly held otherwise. *Allied-Signal*, 504 U.S. at 778 ("in the case of a tax on an activity, there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax") (citing *Quill*, 504 U.S. at 306-308). Illinois's proposed rule would overrule a century of precedent, including this Court's repeated resistance to efforts by States to tax economic activity occurring outside their borders. *See Wallace*, 253 U.S. at 69 ("The only reason for allowing a State to look beyond its borders when it taxes the property of foreign corporations is that it may get the true value of the things within it, when they are part of an organic

system of wide extent, that gives them a value above what they would otherwise possess."); *Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194, 222 (1897) ("We repeat that, while the unity which exists may not be a physical unity, it is something more than a mere unity of ownership. It is a unity of use, not simply for the convenience or pecuniary profit of the owner, but existing in the very necessities of the case,—resulting from the very nature of the business.").

Illinois's narrow focus on factors that demonstrate no more than the existence of a corporate connection between Mead and Lexis/Nexis as a basis for taxing an apportioned share of Mead's gain from the sale of Lexis/Nexis cannot be squared with this Court's precedents. Indeed, that position is almost indistinguishable from one repeatedly rejected by this Court: that "all income of a corporation doing any business in a State is, by virtue of common ownership, * * * apportionable." *Allied-Signal*, 504 U.S. at 784; *see also ASARCO*, 458 U.S. at 326 (rejecting Idaho's proposed rule that if intangible property is "acquired, managed or disposed of for purposes relating or contributing to the taxpayer's business" then it "should be considered a part of a unitary business"). This Court, however, has refused to "accept, consistent[] with recognized due process standards, a definition of 'unitary business' that would permit nondomiciliary States to apportion and tax dividends '[w]here the business activities of the dividend payor have nothing to do with the activities

of the recipient in the taxing States * * * .'" *ASARCO*, 458 U.S. at 327 (quoting *Mobil Oil*, 445 U.S. at 442).[12]

3. The shortcomings of the decision below are reflected in the fact that it conflicts with the decisions of other state courts. Indeed, state high courts that have considered these issues have not held that the mere existence of any economic contribution between a business and its nonunitary asset eliminates the requirement that the nonunitary asset be used operationally by the unitary business before the State can tax.

Thus, in *Hercules Inc. v. Commissioner of Revenue*, 575 N.W.2d 111, 117 (Minn. 1998), and *Hercules Inc. v. Comptroller of Treasury*, 716 A.2d 276, 282 (Md. 1998), the state courts of last resort in Minnesota and Maryland found that a nonunitary

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[12] By proposing a rule that would allow States to tax income or gain bearing no relationship to a business's activities *in* those States, Illinois is running against a wealth of academic scholarship. *See, e.g.*, Jerome Hellerstein, *Allocation and Apportionment of Dividends and the Delineation of the Unitary Business*, 14 TAX NOTES 155, 160 (1982) (if value is "derived" from a source outside the taxing State, and the value-generating asset is not "used in the unitary business conducted in the State, either as working capital or under the *Corn Products* analogy or otherwise," there is no justification for apportionment); Walter Hellerstein, *State Taxation of Corporate Income from Intangibles:* Allied-Signal *and Beyond*, 48 TAX L. REV. 739, 858 (1993); Note, *State Taxation of Foreign-Source Income*, 66 CORNELL L. REV. 805, 806 (1981); William D. Dexter, *Tax Apportionment of the Income of Unitary Business: An Examination of* Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 1981 BYU L. REV. 107, 119-20 (1981).

asset served no operational function, even though the two lines of business complemented and provided one another certain goods and services. Both courts held that their respective States could *not* tax an apportioned share of the gain from the sale of a nonunitary asset.

Likewise, the Alaska Supreme Court has held that a definition of "operational income" that applied whenever "investment decisions [are] obviously aimed at building [the corporation's] financial strength overall" "would swallow the distinction between operational and investment income." *Alaska Dep't of Revenue v. OSG Bulk Ships, Inc.*, 961 P.2d 399, 411, 414 (Alaska 1998). Even in decisions where the gain was apportionable, those state courts have confined the operational function test to the two circumstances previously articulated by this Court. *See also Pennzoil Co. v. Department of Revenue*, 33 P.3d 314, 318 (Or. 2001), *cert. denied*, 535 U.S. 927 (2002) (income related to an agreement to guarantee strategic petroleum resources); *Hoechst Celanese Corp. v. Franchise Tax Bd.*, 22 P.3d 324, 345 (Cal.), *cert. denied*, 534 U.S. 1040 (2001) (income producing trust and pension plan was designed "to induce [unitary business's] current employees to stay and to attract new employees").

The fair, predictable and equitable application of the operational function test by these courts demonstrates both that this Court's test works in practice and that adoption of any new rule will disturb settled expectations upon which States and

corporations rely. *Allied-Signal*, 504 U.S. at 785 ("[I]f anything would be unworkable in practice, it would be for us now to abandon our settled jurisprudence defining the limits of state power to tax * * * . State legislatures have relied upon our precedents by enacting tax codes which allocate intangible nonbusiness income to the domiciliary state * * * .").

B. Illinois's Tax Grossly Misattributes Taxes Among Domiciliary States and Non-Domiciliary States

If this Court were to adopt the Illinois court's holding that *ownership* is the linchpin of apportionability, not only would taxpayers' due process rights be affected, but severe income misattribution would occur. *See* Walter Hellerstein, *supra*, at 806. States would tax income that is in no way related to the taxpayer's activities in the State. Both corporations and States' administrators would face significant difficulties in applying apportionment formulae that have been in place for more than 50 years to income or other gain that has never been previously included in the apportionable tax base.

Misattribution of taxable income would strip States of legitimate claims to those portions of a multi-state corporation's tax base that would be arbitrarily assigned to other States. *See* Walter Hellerstein, *supra*, at 806-807. The fact that States stripped of legitimate tax revenue under an "ownership equals apportionment" rule would be able

to tax *other* income that they would not have been able to tax otherwise is inconsequential because this Court has held that "[w]e can accept the premise that apportionment is permitted only when precise geographic measurement is not feasible, for to allow apportionment where there is no practical or theoretical justification could provide the opportunity for a State to export tax burdens and import tax revenues." *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358, 374 (1991).

All of this would increase the need for judicial monitoring: "Without the unitary business principle to serve as a prophylactic device to confine the tax base to income arising from a related set of activities, there inevitably would [be] an increase in state tax apportionments that [bear] no reasonable relationship to the taxpayer's activities in the state." Walter Hellerstein, *supra*, at 807. Taxpayers, consequently, would seek relief from the courts in greater numbers, thereby reducing the efficiency of both tax collection and the judicial process.

III. The Decision Below Renders The Nation's Largest Corporations Vulnerable To Unconstitutional Duplicative Taxation

The threat of duplicative state taxation and the burden it imposes on interstate commerce is at the heart of this Court's Commerce Clause jurisprudence relating to state taxation of multi-state businesses.

Protection against duplicative taxation is embodied in the requirement that a State's tax on interstate activity be fairly apportioned. *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 184-185 (1995). The prohibition against duplicative taxation "is threatened whenever one State's act of overreaching combines with the possibility that another State will claim its fair share of the value taxed: the portion of value by which one State exceeded its fair share would be taxed again by a State properly laying claim to it." *Id.* at 184-185. Accordingly, this Court "act[s] as a defense against state taxes which, whether by design or inadvertence, either give rise to serious concerns of double taxation, or attempt to capture tax revenues that, under the theory of the tax, belong of right to other jurisdictions." *Trinova*, 498 U.S. at 386.

The Constitution does not guarantee that a multi-state business will *never* be exposed to *any* overlapping taxation, because even where there has been no overreaching by a State, some risk of duplicative taxation is inherent when various States' inconsistent apportionment schemes apply. That occurs, however, only in circumstances where the taxing States each possess the constitutional authority to tax an apportioned share of the multi-state corporation's gains, not in the circumstances present in the instant case where the taxing State has no such authority at all.

As such, that circumstance arises only because this Court has made it clear that the Constitution does not mandate a single method of tax

apportionment to be used by each State, in part because selecting such an apportionment would involve complex policy questions and would be quintessentially legislative in nature. *See Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 279-280 (1978). Thus, provided that the "tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State," *Oklahoma Tax Comm'n*, 514 U.S. at 183 (quoting *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977)), this Court has upheld tax-apportionment schemes despite a minor, "limited possibility of multiple taxation," *Goldberg v. Sweet*, 488 U.S. 252, 264 (1989). Nevertheless, when examining "whether a State's tax reaches beyond that portion of value that is fairly attributable to economic activity within the taxing State[,] * * * the threat of real multiple taxation * * * may indicate a State's impermissible overreaching." *Oklahoma Tax Comm'n*, 514 U.S. at 185.

This is not a case where there is a limited risk of duplicative taxation due solely to the applications of various state apportionment formulae. Rather, Illinois has taxed a gain that could be taxed in a manner consistent with the Constitution only by Ohio, because Lexis/Nexis was not a part of Mead's unitary business of manufacturing and sale of paper

and office supplies and served no operational function to that unitary business.[13]

Nor is the threat of duplicative taxation inchoate. States have relied on this Court's precedents and have established tax schemes allocating the entirety of intangible nonbusiness income to the domiciliary State. *Allied-Signal*, 504 U.S. at 785; *see also* pages 47-49 *supra* (demonstrating the divergent manner Illinois's sister States have addressed the operational function test). The Illinois court's decision, if permitted to stand, impermissibly permits a State with no nexus to a capital transaction to impose a duplicative tax on a portion of that transaction, despite the domiciliary State's right to tax the entirety of the same transaction. *See Central Greyhound Lines, Inc. v. Mealey*, 334 U.S. 653, 662-663 (1948) (holding that a State's duplicative tax on the entirety of transaction was unconstitutional where two other States had the right to tax an apportioned share).

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[13] That Ohio's tax code may not actually tax the entire transaction is of no consequence. *See Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207, 228-229 (1980) ("[T]he constitutionality of [one State's] tax should not depend on the vagaries of [another State's] tax policy * * * ." (quoting *Mobil Oil*, 445 U.S. at 444 (second brackets in original))); *Central Greyhound Lines, Inc. v. Mealey*, 334 U.S. 653, 663 (1948) (stating that other States' lack of taxation on an interstate transaction would not justify a State's overreaching by taxing a greater portion of the transaction than it was entitled to). Illinois cannot extend its taxation beyond constitutional limits merely because one of its sister States may decide not to tax to the fullest extent permissible under the Constitution.

CONCLUSION

For the reasons set forth above, the judgment of the Appellate Court of Illinois should be reversed.

Respectfully submitted,

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In the Supreme Court of the United States

THE MEADWESTVACO CORPORATION, SUCCESSOR IN INTEREST TO THE MEAD CORPORATION, PETITIONER,

v.

ILLINOIS DEPARTMENT OF REVENUE, DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE, AND TREASURER OF THE STATE OF ILLINOIS, RESPONDENTS.

On Writ of Certiorari to the Appellate Court of Illinois

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QUESTION PRESENTED

Whether Mead proved by clear and cogent evidence that the Constitution prohibits Illinois from taxing a fraction of the billion-dollar gain that Mead realized from the sale of Lexis/Nexis, its electronic publishing division, a business that Mead actively conducted in Illinois for nearly two decades.

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BRIEF FOR RESPONDENTS

STATEMENT

The Relationship between Mead and Lexis/Nexis

1. Mead supported Lexis/Nexis for years before it became profitable.

Mead (now "Meadwestvaco") Corporation ("Mead"), an Ohio domiciliary and Illinois taxpayer, purchased Data Corporation in 1968 for approximately $6 million. J.A. 9, 152-53. Although Mead was interested in Data Corporation primarily for its ink jet printing technology, which potentially related to Mead's paper and office supplies business, J.A. 152, Data Corporation's products also included a full-text information retrieval technology originally developed for the United States Air Force. J.A. 152-53.

Shortly after acquiring Data Corporation, Mead transferred its information retrieval line to a wholly owned subsidiary called Mead Data Central ("MDC"). J.A. 9. Working with the Ohio and Missouri Bar Associations, MDC transformed this product into a computer-assisted legal research service, which MDC launched in 1973 as Lexis. J.A. 153.[1]

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[1] In addition to Lexis, MDC also came to include Nexis, a computer-assisted news, financial, marketing, and general information retrieval service, as well as several other businesses. J.A. 99-100. Although Mead never formally changed MDC's name, MDC was referred to as "Lexis/Nexis" during the proceedings

Lexis/Nexis was not immediately successful, J.A. 154, and did not become profitable until the late 1970s, J.A. 154-55. Prior to that time, Mead kept Lexis/Nexis afloat with capital contributions. J.A. 169. Lexis/Nexis came to do substantial business in Illinois, and it headquartered its Lexis Document Services in Springfield. J.A. 14, 104.

2. Mead supported Lexis/Nexis financially and oversaw critical decision-making.

Even after Lexis/Nexis became profitable, Mead continued to provide needed operating resources and to take an active role in its economic decision-making. The record includes numerous examples. In 1984, Mead's Corporate Objectives Committee ("Committee"), having been "impressed with the growth and general development of [Lexis/Nexis] and its strong position in the electronic publishing field," concluded that its "sale or other disposition * * * should not be pursued." J.A. 132. Instead, the Committee "encouraged [Lexis/Nexis] management to continue to develop growth plans for this division, including potential acquisitions, and requested that each such acquisition be presented to the Committee for its consideration." *Id.* Shortly thereafter, Mead's Board of Directors ("Board") approved a request by Lexis/Nexis to undertake two significant capital projects. The first was to acquire additional central processing units, at a cost of up to $7.67 million, with Mead itself entering into a lease agreement to procure the units "for use at Mead Data Central division"; the second was to spend

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below. For consistency, respondents use that designation.

$1.65 million to expand Lexis/Nexis's computer center. J.A. 132-33.

Other examples of Mead's support for Lexis/Nexis and close involvement in its management abound. In 1993, Mead's Board approved a $12.9 million expansion of the computer and data storage capacity for Lexis/Nexis's "'Freestyle' search system." J.A. 135. The following year, the Board approved an additional $9.1 million to further increase Lexis/Nexis's computer capacity. J.A. 137. At the same time, Mead authorized Lexis/Nexis to enter into a partnership with American Lawyer Media to create an online communication and conferencing system for lawyers, J.A. 137-38, and allowed Lexis/Nexis to contribute up to $10 million to the new partnership, J.A. 138. Also in 1994, Mead's Board authorized Mead to enter into an agreement with Dow Jones & Company for Lexis/Nexis to distribute certain Dow Jones publications, and formed a committee to approve any distribution agreement. J.A. 141. Finally, that same year, Mead's Board decided to authorize Lexis/Nexis's acquisition of Journal Graphics, Inc. for $6 million, which required Mead itself to pay $200,000 for a related, "standstill agreement." J.A. 144.

3. Mead repeatedly restructured Lexis/Nexis for Mead's tax advantage.

Mead manipulated Lexis/Nexis's corporate form for Mead's own benefit, alternatively treating Lexis/Nexis as a division and a subsidiary, always to collect significant tax savings for Mead. J.A. 14; see also Record Vol. 7, C1741-49. In 1980, for example, Lexis/Nexis, which had been operating as a wholly

owned subsidiary of Mead, was merged into and operated as a Mead division to achieve "projected combined net state income tax savings of $3.0 to $5.0 million over the next five years." J.A. 130-31, 149-50. These tax benefits were available because Lexis/Nexis was not as profitable as Mead at the time, and by treating Lexis/Nexis as a division, Mead could consolidate its own financial results with Lexis/Nexis's for state income tax purposes. J.A. 149.

In 1985, Lexis/Nexis was reincorporated separately for "strategic and tax purposes." J.A. 147. In December 1993, it was merged with Mead again, this time to obtain "substantial state tax savings" estimated to reach "$1.2 million for 1994" and to increase to "$2.5 million [per year] by 2007." J.A. 134, 147. The merger allowed Mead to take advantage of Lexis/Nexis's net operating loss carryforwards. *Id.*[2] Mead paid $350,000 of its own funds to effect this merger. J.A. 134, 147.

4. Mead treated Lexis/Nexis as part of Mead's unitary business for Illinois tax purposes.

Although Mead and Lexis/Nexis filed separate Illinois tax returns for 1988, a Department audit determined that Mead and Lexis/Nexis were unitary businesses. J.A. 13. Mead objected, but to settle the dispute it agreed to treat Lexis/Nexis as part of its unitary business group and to include it in its Illinois

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[2] Net loss carryforwards are tax deductions for losses incurred in one period that may be applied to a later period. See 26 U.S.C. § 172; see also Black's Law Dictionary 227 (West 8th ed. 2004).

combined unitary income tax return, which it did until it sold Lexis/Nexis in 1994. J.A.13; Record Vol. 4, C857-58; Vol. 5, C1105-06, C1120.

Mead's tax returns also show that the Lexis/Nexis publishing division contributed significantly to Mead's overall income. On its 1994 Illinois combined unitary return, Mead reported combined Illinois sales of approximately $338 million, which included nearly $47 million in sales (and property and payroll in excess of $13 million) attributable to the electronic publishing division. Record Vol. 4, C895-96. In fact, of the approximately $3.8 billion in Illinois income that Mead reported between 1988 and 1993, more than $800 million came from Lexis/Nexis. J.A. 14. During these years, Mead also reported approximately $4.5 billion in business expense deductions, more than $680 million of which were attributable to Lexis/Nexis. *Id.*

5. Mead characterized Lexis/Nexis as a business segment rather than an investment.

Throughout this time, Mead consistently described its Lexis/Nexis electronic publishing division as a "business segment," rather than an "investee." In its 1993 annual report, Mead touted itself as a manufacturer and distributor of paper, packaging, and office supplies, as well as "the developer of the world's leading electronic information retrieval services for law, patents, accounting, finance, news and business information." J.A. 59.

In the same annual report, rather than classify the Lexis/Nexis electronic publishing division as an investment, Mead described it as a business segment.

J.A. 80-81. Moreover, Mead cited successes at Lexis/Nexis as examples of Mead's own progress under its "three key initiatives" program, which focused on improving customer satisfaction, productivity, and management performance. J.A. 60-61.

Also in the 1993 annual report, Mead stated that, as part of its effort to improve performance, it had "reorganized its corporate functions," including reallocating certain expenditures among its "operating units." J.A. 85. As a result, Mead reallocated earnings among its "[i]ndustry segments," which by Mead's own description included not only paper, packaging, and office supplies, but also "[e]lectronic [p]ublishing." J.A. 85-86.

Mead likewise described itself as "engaged in the electronic publishing business" in the form 10-K it filed with the Securities and Exchange Commission in 1994, J.A. 92-93, and listed "electronic publishing" as one of its business "[s]egment[s]" rather than as an "[i]nvestee[]," J.A. 93, 99-100, 121-22. Mead also included Lexis/Nexis in its review of its business operations, J.A. 106, 107-08, 120-21, and listed "LEXIS," "Lexpat," and "NEXIS" as trademarks under which Mead "conducts its business" and that are "of material importance to Mead's business," J.A. 102.

6. Mead's dealings with Lexis/Nexis demonstrate a sharing of values.

Mead ran all of its operations, including its electronic publishing division, in a decentralized fashion, Record Vol. 9, RP 109, 111-12, and Lexis/Nexis was subject to Mead's corporate policy requiring sales

between its business segments to occur at substantially the same prices and on substantially the same terms as sales to third-parties, J.A. 127, 163-64.

That being said, Mead reviewed Lexis/Nexis's business plan each year. J.A. 163. Mead also performed a nightly cash sweep of Lexis/Nexis's bank accounts, and managed the money for Lexis/Nexis's benefit "according to whatever investments Mead decided." J.A. 180-81. Mead's witnesses conceded that Lexis/Nexis executives could have invested the company's excess cash themselves, but they chose not to set up "the extensive banking relationships" necessary to do so and to rely instead on Mead's investment decisions. J.A. 180-81. And although a Mead witness stated that there was little sharing of personnel, Record Vol. 9, RP 102, each of the three executives who testified at trial had worked for both Mead and Lexis/Nexis at various points in his career. Record Vol. 9, RP 65-66, 94-96, 114-15. Finally, Mead made Lexis/Nexis part of the "three key initiatives" program, in which Lexis/Nexis enjoyed considerable success. In its 1993 annual report, Mead used Nexis as an illustration of *Mead* having "made an outstanding leap forward" in obtaining customer satisfaction. J.A. 61. Similarly, Mead boasted of Lexis/Nexis's new London processing facility, as well as its newly added search systems and international databases, as examples of the initiatives' success. J.A. 61-63. Mead also highlighted Lexis/Nexis's innovations in modifying search vehicles as emblematic of Mead's new corporate focus on customer satisfaction and "shared values." J.A. 63; Record Vol. 5, C1232.

7. After 26 years in the electronic publishing business, Mead sold Lexis/Nexis in 1994.

In 1994, after studying the "strategic and financial alternatives" for Lexis/Nexis, J.A. 139, Mead's Board decided to sell its electronic publishing division, J.A. 142-43. This plan engendered "considerable discussion" among Board members. J.A. 143. Indeed, for Steve Mason, Mead's chairman and chief executive officer, the decision to sell Lexis/Nexis was "probably the toughest decision I've ever had to make," for Lexis/Nexis was one of Mead's "two very good businesses." J.A. 44. As Mason explained, the decision to sell was particularly "difficult" because Mead had "grown" Lexis/Nexis "since 1968 from a small legal database into the word's premier provider of online legal information and the pioneer in computer-assisted news retrieval." J.A. 33. In deciding to sell Lexis/Nexis, Mead's Board also approved modifications to Mead compensation programs affecting Lexis/Nexis employees, and awarded performance bonuses to certain Lexis/Nexis employees. J.A. 146.

Mead's decision to sell Lexis/Nexis came as a surprise to some industry analysts, who saw Mead as the company that "pioneered the computer information and news retrieval service." J.A. 50. Moreover, Mead had "always done a lot of fixing of its [electronic publishing] product," which remained one of Mead's "growth industries." *Id.* But Mead found "a lot of market interest" in Lexis/Nexis and, in December 1994, sold the electronic publishing division for $1.5 billion. J.A. 87-88. Mead used the proceeds from the sale to buy back stock and retire Mead debt, reducing Mead's vulnerability to a takeover. J.A. 15, 87-88.

Proceedings Below

1. Mead did not report the gain from the sale of Lexis/Nexis as taxable income in Illinois.

On Mead's 1994 Illinois combined unitary return, which a Mead director signed "[u]nder penalt[y] of perjury," Mead treated Lexis/Nexis's ordinary income from that year as apportionable business income, Record Vol. 4, C850—meaning Illinois could tax a share of it.[3] However, although Mead realized a $1.05 billion gain from the sale of its electronic publishing business, Mead claimed that this income, most of it attributed to "goodwill," was nonapportionable nonbusiness income and therefore not subject to Illinois tax. J.A. 5, 8, 53, 55.

After an audit, the Illinois Department of Revenue ("Department") concluded that Mead's gain from the sale of Lexis/Nexis was apportionable business income,

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[3] Illinois law distinguishes between apportionable, "business income" and nonapportionable, "nonbusiness income." 35 ILCS 5/303, 5/304 (2006). In 1994, Illinois law defined "business income" as "income arising from transactions and activity in the regular course of the taxpayer's trade or business," which "include[d] income from tangible and intangible property if the acquisition, management, and disposition of the property constitute[d] integral parts of the taxpayer's regular trade or business operations." 35 ILCS 5/1501(a)(1) (1994). This tracked the definition of business income in the Uniform Division of Income for Tax Purposes Act ("UDITPA"). See *Texaco-Cities Serv. Pipeline Co. v. McGaw*, 695 N.E.2d 481, 484 (Ill. 1998). In 2003, Illinois amended its law to encompass all income that is constitutionally apportionable. See 35 ILCS 5/1501(a)(1) (2006). The 2003 amendment did not, as Mead implies, see Pet. Br. 5 n.1, narrow Illinois's definition of business income.

and that at least a small part of it should have been included in Mead's Illinois taxable income. J.A. 5-6, 26, 55; Record Vol. 9, RP 228. As the Department explained, "[s]ince all aspects of a business contribute[] to its goodwill," some "portion of the gain of goodwill * * * would be attributable to Illinois." J.A. 55.

In determining how much of the gain was subject to Illinois tax, the Department applied Illinois's version of the long-accepted, multi-factor apportionment formula. See *Barclay Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298, 304 (1994). Under this formula, as Illinois employed it in 1994, the portion of a multistate corporation's business income that is subject to Illinois tax is determined by averaging three "factors": the corporation's Illinois property as a fraction of all of its property; the corporation's Illinois payroll as a fraction of all of its payroll; and the corporation's Illinois sales as a fraction of all of its sales. See 35 ILCS 5/304(a) (1994). These factors are calculated in fractions or percentages, and are themselves averaged (with the sales factor double weighted) to produce a single fraction reflecting the share of the taxpayer's business that occurred in Illinois. See *id.*[4]

In apportioning the gain from the Lexis/Nexis sale, the Department included the approximately $1.05 billion gain in Mead's sales factor denominator (as part of Mead's total sales) but included only about $40.6 million of it (approximately 3.7% of the total gain) in

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[4] In 1999, Illinois began moving to a single-factor apportionment method based solely on sales. See 35 ILCS 5/304(h) (2006).

Mead's sales factor numerator (representing the portion of Mead's sales that occurred in Illinois). J.A. 189. The $40.6 million was calculated using only *Lexis/Nexis's* payroll and sales factors, in an effort to capture only the portion of the total goodwill that was fairly attributable to Lexis/Nexis's activity in Illinois. J.A. 55, 186, 189. This figure was included in the sales factor numerator along with Mead's other Illinois receipts, and the gain was then apportioned using Mead's property, payroll, and sales factors, which averaged about 4.1% of Mead's overall business activity, J.A. 28, 55, nearly identical to the average generated using Lexis/Nexis's factors alone. That ratio then was multiplied by Mead's taxable income, which included the Lexis/Nexis gain. J.A. 28. Partly as a result of this additional income apportioned to Illinois, the Department issued two notices of deficiency for additional tax and interest. J.A. 22-31.[5]

2. The Illinois courts upheld the Department's determination that Illinois may tax a fraction of Mead's gain from the sale of Lexis/Nexis.

Mead challenged the deficiency notices in the Illinois courts, where a trial was held on stipulated

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[5] The two notices included some offsetting items, but the resulting total deficiency was $3,149,222 in tax and $1,049,017 in interest. J.A. 6. Although not clearly reflected in the record, most of Mead's increased tax liability was due to the inclusion of the gain from the sale of Lexis/Nexis in Mead's Illinois apportionable tax base. The remaining significant portion of the deficiency arose from a state law issue resolved in the Department's favor, Pet. App. 18a-22a, and that issue is not before the Court.

facts, exhibits, and testimony.[6] Mead argued that the Federal Constitution did not permit Illinois to tax any of the gain Mead realized from the sale of Lexis/Nexis because, according to Mead, Lexis/Nexis had no connection with the paper, packaging, and office supply business that Mead admittedly operated in Illinois. Record Vol. 8, C1786-95. Mead also claimed that by apportioning a part of the gain to Illinois, the Department had unconstitutionally distorted the share of Mead's income attributable to Illinois. Record Vol. 8, C1795-96.

For its part, the Department argued that the approximately 4% of the $1.05 billion gain that it had attributed to Illinois was properly apportionable under any one of three related theories: (1) the electronic publishing business (Lexis/Nexis) was one of the businesses that Mead conducted in Illinois; (2) Mead and Lexis/Nexis were part of a "unitary" multistate enterprise; and (3) Lexis/Nexis was an operational asset of Mead. Pet. App. 35a-40a; Record Vol. 8, C1841-42, C1847-54. As the Department explained, for any or all of these reasons, there was a sufficient nexus between the Lexis/Nexis division and Illinois to subject a part of the gain to Illinois tax. Record Vol. 8, C1841-42, C1847-54. In addition, the Department indicated that it had isolated the Lexis/Nexis assets located in Illinois and had apportioned to Illinois only the

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[6] Mead's complaint named the Illinois State Treasurer ("Treasurer"), as well as the Department. Under Illinois law, the Treasurer is responsible for maintaining the protest fund into which Mead paid the disputed amounts. See 30 ILCS 230/1 – 230/2a.1 (2006). None of the arguments here relate to the Treasurer's role in this case.

goodwill associated with those Illinois assets, to ensure that no out-of-state value was taxed. *Id.* at C1847.

The trial court found that "at all relevant times" Mead was "involved in the electronic publishing business" through its "business operations" in Lexis/Nexis, Pet. App. 36a-37a, and that "[t]he sale of Lexis/Nexis included assets which were situated in Illinois and used in the production of income reported to Illinois." *Id.* at 37a. Ultimately, the court determined that Lexis/Nexis served "an operational purpose" for Mead. *Id.* at 38a. This was because "Lexis/Nexis represented a significant business segment of Mead," meaning "Lexis/Nexis was considered in the strategic planning of Mead, particularly the allocation of resources." *Id.* "The operational purpose allowed Mead to limit the growth of Lexis/Nexis, if only to limit its ability to expand or to contract through [Mead's] control of its capital investment." *Id.* at 38a-39a. Based on these findings, the trial court determined that although Mead and its electronic publishing business were not a "unitary" business, the Department had properly concluded that a fraction of the gain Mead realized in selling Lexis/Nexis was constitutionally apportionable business income subject to Illinois tax. *Id.* at 39a-40a.

The Illinois Appellate Court affirmed, upholding the lower court's determination that Lexis/Nexis served an operational function for Mead, because Lexis/Nexis had the requisite constitutional nexis with Illinois. Pet. App. 11a. Specifically, the appellate court held that Mead failed to meet its burden of proving that the trial court's finding of operational

purpose was against the manifest weight of the evidence. *Id.* at 14a. The appellate court reasoned that the operational purpose finding was more than adequately supported by the undisputed evidence that Mead was the 100% owner of Lexis/Nexis and was far more than a passive investor. *Id.* at 12a-13a. Mead had contributed capital to Lexis/Nexis, approved major expenditures, manipulated Lexis/Nexis's corporate structure, retained its tax benefits, and exercised control over Lexis/Nexis's excess cash. *Id.* at 13a. In addition, Mead's annual report and SEC filing demonstrated that Mead considered itself to be in the electronic publishing business, and viewed Lexis/Nexis as a business segment rather than an investee. *Id.* Because it determined that Lexis/Nexis served an operational function, the appellate court expressly declined to address the Department's argument that Mead and Lexis/Nexis were also unitary businesses, an alternative basis to uphold the Department's tax. *Id.* at 11a.

Finally, the appellate court noted that although Mead had argued that the Department's inclusion in Mead's Illinois tax base of a part of the gain from its sale of Lexis/Nexis had resulted in an unconstitutionally "disproportionate" share of Mead's income being apportioned to Illinois, Mead never petitioned the Department for alternative apportionment, as Illinois law permits. Pet. App. 17a (citing 35 ILCS 5/304(f) (2004)).

The Illinois Supreme Court denied Mead's petition for leave to appeal from the decision of the appellate

court. Pet. App. 41a. This Court granted Mead's certiorari petition.

SUMMARY OF ARGUMENT

Mead's view that the Constitution does not permit Illinois to tax even a fraction of the $1.05-billion gain Mead realized from the sale of Lexis/Nexis, the electronic publishing division Mead operated in Illinois, is incorrect. The Due Process and Commerce Clauses permit a State to tax income arising from business activity within its borders. In this way, a State may seek a return on "opportunities which it has given, * * * protection which it has afforded, [and] benefits which it has conferred" upon in-state commercial activity. *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1941).

The tax at issue here was proper for any one of several, independent reasons. First, it is well settled that an out-of-state company is subject to tax in any State in which the company does business. Mead itself actively conducted an electronic publishing business in Illinois (and elsewhere) through Lexis/Nexis. Not only did Lexis/Nexis carry on substantial business and maintain a physical presence in Illinois, but Mead controlled Lexis/Nexis in myriad ways. Mead was, in its own words, "engaged in the electronic publishing business," J.A. 59, and because that business was conducted in Illinois, Illinois was entitled to tax its fair share of any income it accrued.

Second, Mead and Lexis/Nexis functioned as a unitary business or, at the very least, Lexis/Nexis was an operational asset of Mead. On the former point,

because Mead provided capital support and investment oversight to Lexis/Nexis, managed Lexis/Nexis's more significant expenditures, infused Lexis/Nexis with its management principles, held itself out to the world as a leader in electronic publishing, and even included Lexis/Nexis on its unitary tax returns, decisions of this Court require a finding of a unitary relationship here.

Moreover, even in the absence of business unity, the record amply supports a finding that Lexis/Nexis was an operational asset of Mead. In addition to the facts discussed above, Mead also regularly manipulated Lexis/Nexis's corporate form to appropriate its loss carryforwards as valuable tax savings. This is no different from purchasing paper or other products from Lexis/Nexis at below-market rates, precisely the type of activity this Court has recognized as satisfying the operational function test.

Mead seeks to avoid this result by arguing that the operational function test is but a "narrow exception" to the unitary business principle and that any fact tending to show a unitary business is immaterial to the operational function analysis. But *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992), makes clear that the operational function test is not limited to the one or two illustrations provided therein, and, moreover, that the unitary business and operational function doctrines are not mutually exclusive. Thus, it is perfectly proper to support an operational function finding with facts that would also tend to show a unitary business.

Mead also attempts to avoid any tax by arguing that Lexis/Nexis was nothing more than a "passive investment," but this is flatly belied by the record. To be sure, Mead conducted all of its businesses in a decentralized fashion, and Lexis/Nexis was no exception. But the depth of Mead's involvement in Lexis/Nexis—managing it, manipulating it, and the very public marketing of it—are all characteristic of conducting a business and not simply investing in one.

In any event, even if Mead were merely a passive investor in Lexis/Nexis, Illinois's tax would not run afoul of the Constitution. To the contrary, a State may tax the income an out-of-state corporation derives even from its investment in another out-of-state corporation, so long as the tax fairly reflects the portion of the income that the latter generated within the taxing State's borders. Here, by including only about $40.6 million of the $1.05 billion gain to Mead in the apportionments factors, Illinois properly sought to tax no more than the portion of the gain that was attributable to Illinois.

Indeed, contrary to Mead's claim, sustaining Illinois's tax here raises no threat of prohibited multiple taxation. Mead never presented any evidence that multiple taxation will occur if this tax is upheld. Moreover, in *Mobil Oil Co. v. Comm'r of Taxes*, 445 U.S. 425 (1980), this Court squarely held that the risk of multiple taxation under circumstances analogous to these does not violate the Constitution because the constitutionality of one State's tax should not depend on the vagaries of another State's tax policy.

ARGUMENT

I. A State May Tax A Business With Which It Has The Minimum Constitutional Nexus.

Mead's challenge turns on a single question: Does Lexis/Nexis have the minimum ties to Illinois needed to subject a fraction of the gain realized upon its sale to Illinois tax (any fraction, for Mead does not protest the portion of the Lexis/Nexis gain that Illinois taxed, but the fact that Illinois taxed that gain at all). The Due Process and Commerce Clauses each require "some minimum connection" between a State and the activity it taxes. *Allied-Signal,* 504 U.S. at 777 (internal quotation marks omitted); see also *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 165-66 (1983).

This "minimum connection" requirement allows States to tax entities that derive some benefit from a State's law, infrastructure, or citizenry. The bedrock constitutional principle is that "[a] state is free to pursue its own fiscal policies, unembarrassed by the Constitution, if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given, to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society." *J.C. Penney*, 311 U.S. at 444. The ultimate "inquiry in a case such as this, therefore, is whether the taxing power exerted by the state bears fiscal relation to the protection, opportunities and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return." *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S.

307, 315 (1982) (internal quotation marks omitted); see also *Allied-Signal*, 504 U.S. at 778 ("We are guided by the basic principle that the State's power to tax an individual's or corporation's activities is justified by the protection, opportunities and benefits the State confers on those activities") (internal quotation marks omitted); *J.C. Penney*, 311 U.S. at 442 (State may charge a "price for the privileges it afford[s] foreign corporations within its borders").

A tax on a nondomiciliary company may satisfy this ultimate constitutional requirement in any one of several ways. Most obviously, an out-of-state company is subject to tax in any State in which it actually conducts business. See, *e.g.*, *J.C. Penney*, 311 U.S. at 441 (recognizing established principle that a "state has, of course, power to impose a tax" on "corporations chartered by other states but permitted to carry on business in" the taxing State). This includes the State's power to tax dividends on income derived from property located and business transacted in the taxing State by a nondomiciliary company, see *id.* at 441-46 (rejecting due process challenge to Wisconsin tax on share of dividends issued by nondomiciliary corporation), even if this tax is imposed on a wholly out-of-state investor who receives the income, rather than on the payor who is engaged in the in-state business, see *Int'l Harvester Co. v. Wis. Dep't of Taxation*, 322 U.S. 435, 442, 445 (1944) (upholding Wisconsin tax on out-of-state shareholders' "privilege of receiving dividends" issued by nondomiciliary corporations engaged in business in Wisconsin because

Wisconsin "afforded protection and benefits to [corporations'] activities and transactions within the state").

States also may include in their apportionable tax base income generated by entities outside the taxing jurisdiction, so long as these entities are part of a "unitary" business, some part of which conducts business in the taxing State. Thus, this Court held in *Mobil Oil* that Vermont could tax Mobil's return on its "investments in affiliates and subsidiaries operating abroad," because Mobil did some business in Vermont and, although the affiliates and subsidiaries did not, they belonged to Mobil's unitary business. *Id.* at 435, 439-42 (internal quotation marks omitted). Likewise, the question in *F.W. Woolworth Co. v. Taxation & Rev. Dep't of N.M.*, 458 U.S. 354 (1982), was whether Woolworth conducted a unitary business with certain "foreign subsidiaries that [did] no business in New Mexico," which would allow the State to tax a share of the dividends that Woolworth received from those subsidiaries, *id.* at 356; and in *ASARCO*, it was whether Idaho could tax intangible income that a nondomiciliary company doing business in Idaho "receive[d] from subsidiary corporations having no other connection with the State," 458 U.S. at 308-09. By engaging in a unitary enterprise with a company acting in-state, even an entity with no other ties to the State maintains "the necessary relationship to opportunities, benefits, or protection conferred or afforded by the taxing State." *Woolworth*, 458 U.S. at 372 (internal quotation marks omitted).

Nor is business unity always required to tax even such far-flung subsidiaries or investees. "To be sure,

the existence of a unitary relation between the payor and the payee is one means of meeting the constitutional requirement" of minimal nexus, but it is "not the only one." *Allied-Signal*, 504 U.S. at 787. "[T]he unitary business concept * * * is not, so to speak, unitary: there are variations on the theme, and any number of them are logically consistent with the underlying principles motivating the approach." *Container Corp.*, 463 U.S. at 167; see also *Allied-Signal*, 504 U.S. at 785 (same). It is enough, for example, that a capital transaction "serve an operational rather than an investment function," even when the payor and payee are not in a unitary relationship. *Allied-Signal*, 504 U.S. at 787.

It is within this constitutional framework that Mead must prove by "clear and cogent evidence" that Illinois's tax on a fraction of the gain realized by the Lexis/Nexis sale was unlawful. *Container Corp.*, 463 U.S. at 175 (internal quotation marks omitted). Mead fails to do so. Without even mentioning that Lexis/Nexis itself had a physical presence and conducted substantial business in Illinois, Mead relies on a narrow, inflexible reading of the "unitary business" and "operational function" doctrines to argue for an exception to States' long-recognized right to tax those who benefit from their "protection, opportunities and benefits." *ASARCO*, 458 U.S. at 315. Illinois sought to tax only a small portion of the more than $1 billion gain that Mead realized from the sale of Lexis/Nexis—a share commensurate with the goodwill value attributable to Lexis/Nexis's operations in Illinois, including its physical presence in-state, its use of Illinois employees, and its millions of dollars in sales

to Illinois consumers. J.A. 5-6, 55, 189. Indeed, had Lexis/Nexis been an independent company and Mead a mere investor who received dividends like other shareholders, the income that Mead received from Lexis/Nexis would have been subject to Illinois tax based on Lexis/Nexis's own Illinois operations. See *Int'l Harvester*, 322 U.S. at 439, 442, 445.

Mead insists, however, that by owning Lexis/Nexis outright and operating it alternately as a subsidiary and a division, without (in Mead's view) ever treating it as an "operational asset" or as part of Mead's "unitary business," it is entitled to a massive return on Lexis/Nexis's goodwill without subjecting even a fraction of that return to Illinois tax. In the constitutional middle ground that Mead envisions, a corporate division may do substantial business in a State—or nearly all of its business, for Mead's constitutional theory does not depend on the share of Lexis/Nexis's operations that occurred in Illinois—and therefore benefit substantially from the State's laws, infrastructure, and citizenry, without compensating the State for those benefits. As developed more fully below, this claim fails on several independent grounds.

II. The Constitution Permits Illinois To Tax An Apportioned Share Of The Lexis/Nexis Gain.

Under any standard, Illinois' claim to an apportioned share of the gain from Mead's sale of Lexis/Nexis was not an unconstitutional, extraterritorial tax. Lexis/Nexis was not a passive investment; Mead was conducting the electronic publishing business of Lexis/Nexis in Illinois either directly or through its unitary or operational

relationship with Lexis/Nexis. And even if one accepts Mead's view that Lexis/Nexis was a passive investment, the amount of the gain apportioned to Illinois fairly reflects Lexis/Nexis's activities in Illinois alone. For any or all of these reasons, Illinois is appropriately taxing only the income that arose in-state.[7]

A. Mead Actively Conducted Lexis/Nexis's Electronic Publishing Business In Illinois.

It is well settled that an out-of-state company is subject to tax in any State in which it conducts business. See *supra* pp. 18-19. Thus, in *Northwestern States Portland Cement Co. v Minnesota,* 358 U.S. 450 (1959), this Court rejected a constitutional challenge to a state tax on the portion of a nondomiciliary's net

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[7] The trial court upheld the tax at issue based on its determination that Lexis/Nexis served an operational function for Mead, Pet. App. 38a-40a, and the appellate court affirmed, Pet. App. 11a. As appellees, we may urge the Court to affirm the appellate court's judgment on any ground supported by the record. See, *e.g.*, *Thigpen v. Roberts*, 468 U.S. 27, 30 (1984); *United States v. N.Y. Tel. Co.*, 434 U.S. 159, 166 n.8 (1977); *Langes v. Green*, 282 U.S. 531, 538-39 (1931). Moreover, that we limited our Brief in Opposition to the operational function analysis—the basis for the appellate court's ruling—should be of no consequence. Consideration of our alternative arguments is "'predicate to an intelligent resolution of the question presented.'" *Caterpillar, Inc. v. Lewis*, 519 U.S. 61, 75 n.13 (1996) (quoting *Ohio v. Robinette*, 519 U.S. 33, 38 (1996)). All of our arguments are "fairly included" within the question presented, U.S. Sup. Ct. R. 14.1(a), and may properly be considered by this Court, see *Caterpillar*, 519 U.S. at 75 n.13; *Robinette*, 519 U.S. at 38; *Vance v. Terrazas*, 444 U.S. 252, 258-59 n.5 (1980).

income earned from business activities within the taxing State. See *id.* at 457-65.[8] In particular, the Court sustained efforts by Georgia and Minnesota to tax the income of out-of-state corporations, because the corporations had both solicited and obtained sales in these States. See *id.* at 453-57, 465. This was so even though the corporations at issue maintained nothing more than a sales office in the taxing States. See *id.* at 454-55. The States' income tax was proper, the Court explained, because, when a corporation "engage[s] in substantial income-producing activity" within a State, that State is entitled to ask that the corporation "carr[y] its fair share of its costs of the state government in return for the benefits it derives from within the State," *id.* at 462.

This case is no different. As the trial court correctly found, Mead itself actively conducted an electronic publishing business in Illinois (and elsewhere) through its Lexis/Nexis electronic publishing division. Pet. App. 36a-37a ("at all relevant times prior to the sale of Lexis/Nexis," Mead was "involved in the electronic publishing business" through its "business operations" in Lexis/Nexis). That is, as Mead's CEO acknowledged, Mead operated "two very good businesses," J.A. 44—a paper and packaging business and an electronic publishing business. In

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[8] In response to *Northwestern States'* constitutional holding, Congress enacted Public Law 86-272, which prohibits a State from taxing the income of a corporation whose only business activity within the State consists of "solicitation of orders" for tangible goods. 15 U.S.C. § 381(a); see *Wis. Dep't of Revenue v. Wrigley*, 505 U.S. 214, 232 (1992). Of course, Lexis/Nexis's activity went well beyond what the statute protects, and this law therefore has no bearing on the instant case.

short, Mead did not and cannot clearly and cogently disprove that it was conducting an electronic publishing business in Illinois, and this alone is grounds to affirm the decision below, separate and apart from the unitary business or operational function tests. See *Int'l Harvester*, 322 U.S. at 444-45; *J.C. Penney*, 311 U.S. at 441-42.[9]

In particular, the record amply demonstrates not only that the Lexis/Nexis electronic publishing division engaged in substantial business in Illinois, J.A. 14, and even maintained a physical presence there—Lexis Document Services headquarters were located in Springfield, Illinois, J.A. 104—but also that Mead controlled its electronic publishing division in numerous ways. Mead decided how Lexis/Nexis was managed and how and when it grew; Mead restructured Lexis/Nexis's corporate form, made its investment decisions, and even established the compensation Lexis/Nexis executives received upon divestiture; Mead imposed its management style and initiatives on Lexis/Nexis and shared its personnel; and, finally, Mead portrayed itself in the marketplace as a leader and innovator in the electronic publishing industry, and, not surprisingly, the marketplace perceived Mead exactly the same way.

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[9] This argument was not addressed in *Allied-Signal* or *ASARCO*, which limited their analyses to the unitary business and, in the case of *Allied-Signal*, operational function, tests. See *Allied-Signal*, 504 U.S. at 788-90; *ASARCO*, 458 U.S. at 320-29. In both cases, the taxpayer either lacked or declined to exercise control, and thus did not actively conduct the business at issue. See *infra* p. 39.

To start, Mead provided vital capital contributions until Lexis/Nexis became profitable, J.A. 169, and then, once Lexis/Nexis became successful, Mead encouraged and guided its growth through financial support and oversight of critical decision-making. To that end, Mead participated in and approved numerous acquisition decisions for Lexis/Nexis, as well as helped to implement those major purchases. J.A. 132-33. It was Mead, not Lexis/Nexis, that leased the $7.67 million central processing units "for use at Mead Central Data division." J.A. 132-33. And Mead authorized Lexis/Nexis to enter into agreements with other companies and spoke on behalf of Lexis/Nexis in executing those agreements. Indeed, in 1994 alone, Mead authorized Lexis/Nexis to enter into a partnership with American Lawyer Media and to contribute up to $10 million to that partnership, J.A. 137-38; entered into an agreement with Dow Jones & Company for Lexis/Nexis to distribute Dow Jones publications, J.A. 141; and approved Lexis/Nexis's acquisition of Journal Graphics, paying $200,000 out of its own pocket for the standstill agreement required by that acquisition, J.A. 144.

Mead exercised its control over Lexis/Nexis in myriad other ways. Most significantly, Mead repeatedly restructured Lexis/Nexis's corporate form. In 1980, Mead merged Lexis/Nexis, which had been operating as a wholly owned subsidiary, into Mead as a corporate division. J.A. 130-31. Then, in 1985, Mead separately reincorporated Lexis/Nexis, J.A. 147, only to merge it into Mead again in 1993, J.A. 134. Above and beyond the manipulation of Lexis/Nexis's corporate form, the record discloses other less striking but no less significant ways in which Mead exercised its control.

For example, Mead regularly reviewed Lexis/Nexis's business plan. J.A. 163. Mead undertook a nightly cash sweep of Lexis/Nexis's accounts, and Mead, not Lexis/Nexis, decided how to invest Lexis/Nexis's excess cash. J.A. 180-81. Similarly, when Mead sold Lexis/Nexis, it was Mead that determined what compensation and bonuses the Lexis/Nexis executives would receive. J.A. 146.

Mead also imposed its management style and initiatives on Lexis/Nexis and shared personnel. Lexis/Nexis thus participated in Mead's "three key initiatives" improvement program, and by all accounts did so successfully—showing marked improvements in customer satisfaction and high performance management, two of the "initiatives." J.A. 60-63. And while a Mead witness denied any sharing of personnel, each of the three executives who testified at trial admitted that he had worked for Mead and Lexis/Nexis at various points in his career. Record Vol. 9, RP 66, 94-96, 102, 114-15.

This level of involvement demonstrates conclusively that Mead was the operator not solely of a paper and packaging business, but also of an electronic publishing business. Indeed, Mead has never provided any authority that such activities are indicative of a passive investment. Corporate directors are not just a "passive instrumentality." 1-1 William E. Knepper & Dan A. Bailey, Liability of Corporate Officers & Directors § 1.02, at 1-5 (Allen Smith Co. 7th ed. 2006), as Mead seems to think, see Pet. Br. 34-36. Rather, they are "agents entrusted with the management of the corporation for the benefit of the stockholders." William E. Knepper, Liability of

Corporate Officers & Directors § 1.03, at 8 (Allen Smith Co. 1969) (citing *Pepper v. Litton*, 308 U.S. 295 (1939)). Indeed, if Mead's Board members had harbored no more than a passing interest in Lexis/Nexis's overall profitably, as Mead suggests, they likely would have contravened their corporate duties.

And, of course, Mead and its Board did have much more than a passing interest in Lexis/Nexis. That this is true is demonstrated by how Mead depicted itself to the world. Mead portrayed itself to the government, the public, and current and potential investors as a leader in the electronic publishing field. Mead boasted that *it* had developed "the world's leading electronic information retrieval" service. J.A. 59. It treated Lexis/Nexis as a business segment in its annual report and SEC filing, described itself as engaged in electronic publishing, and even listed "LEXIS," "NEXIS" and "Lexpat" as material Mead trademarks. J.A. 92-100, 102, 106-21, 126.

That Mead considered Lexis/Nexis as part of its business and not a mere investment is further shown by Mead's treatment of Lexis/Nexis as part of its own unitary business group for Illinois income tax purposes. J.A. 13. Mead may characterize its decision to include Lexis/Nexis on its Illinois combined unitary tax return as nothing more than an administrative convenience, undertaken to resolve a dis ute with the Department, J.A. 13; Pet. App. 67a n.7, but it is hard to believe that Mead would have included Lexis/Nexis in its unitary business group unless Mead actually

believed it was in the electronic publishing business.[10] After all, a Mead executive signed the unitary tax returns "under the penalt[y] of perjury." Record Vol. 4, C849.

Because Mead held itself out to the world as an electronic publisher, the marketplace predictably viewed Mead as just that. For this reason, an information technology analyst was surprised to learn of Mead's plans to sell "its product"—the computer information service that Mead had "pioneered" and done so much to "fix[]," and that was one of Mead's "growth industries." J.A. 50 (internal quotation marks omitted).

Finally, given the role that Lexis/Nexis played in Mead's bottom line, it is not surprising that Mead considered itself to be in electronic publishing.

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[10] Any implication that Mead included Lexis/Nexis in its unitary tax returns, which it did between 1988 and 1994, under duress is misplaced. As a result of filing this way, Mead benefitted from valuable tax deductions. J.A. 14, 147. Moreover, the Department relied on Mead's unitary filing position, even during the 1994 audit period. J.A. 53; Record Vol. 5, C1120. Mead should not now be allowed to adopt an inconsistent position. See *R.H. Stearns v. United States*, 291 U.S. 54, 61-62 (1934) (describing a duty of consistency in tax filings, to preclude a taxpayer from benefitting from "his own inequity or tak[ing] advantage of his own wrong"); see also *Beltzer v. United States*, 495 F.2d 211, 212-13 (8th Cir. 1974). Even Mead's expert agreed that would be unfair. Record Vol. 9, RP 107-08 (testimony of Walter Hellerstein) ("a business that is, and continues to be, treated as part of a unitary business, up to the time of the sale, and then at the time of the sale, because of an unusual transaction, the conclusion is that this gives rise to nonbusiness income, I regard as unfair from the standpoint of tax policy").

Lexis/Nexis accounted for a substantial share of Mead's business. In Illinois, Lexis/Nexis contributed over 20% of Mead's income from 1988 to 1993; even in 1994, the year it was sold, Lexis/Nexis still generated 13% of Mead's Illinois sales. J.A. 14; Vol. 4, C896.

Notwithstanding the fact that the marketplace viewed Mead exactly as Mead had intended—as an electronic publisher—Mead tries to distance itself from its annual report and SEC filing. See Pet. Br. 40-41; see also Gannett Br. 14-17; COST Br. 15; Disney Br. 17. Mead's claim that these documents show nothing more than how "the company listed its profit entry on a financial statement," Pet. Br. 41 (citation and internal quotation marks omitted), misses the broader narrative import of those public statements. The annual report and 10-K filing demonstrate Mead's view of the scope of its business, and, in so doing, contradict the testimony of Mead's witnesses that Lexis/Nexis was considered merely a passive investment.

Along the same lines, amici's argument that annual reports and 10-K statements are irrelevant because they are governed by a specific accounting rule, "FAS 131," see Gannett Br. 14-16, Disney Br. 18, misses the mark. FAS 131 provides some quantitative basis for including a business as an operating asset. See Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise & Related Information* (1997). But it provides the reporting entity with considerable leeway as to how it characterizes its business. See generally FAS 131; see also 17 C.F.R. § 229.101 (requiring general description of business). Nothing in FAS 131 required Mead to

state that it "manufactures and distributes school and office supplies, distributes paper and other industrial supplies *and is engaged in the electronic publishing business*." J.A. 92-93 (emphasis added).[11]

In sum, Mead's actions, singly or in combination, were not characteristic of a passive investor. To the contrary, Mead was running a multistate electronic publishing business in Illinois and elsewhere through its Lexis/Nexis division; accordingly, Illinois may tax Mead on a fraction of the gain it realized on the sale of that division.

B. Lexis/Nexis Was Part Of Mead's Unitary Business Or Was An Operational Asset of Mead.

Even if this Court were to conclude that Mead did not actively engage in the electronic publishing business through Lexis/Nexis, the record demonstrates that Mead's paper and packaging business and its electronic publishing line had a unitary relationship or, as both Illinois courts found, that Lexis/Nexis was an operational asset of Mead. Either way, Mead was not merely a passive investor in Lexis/Nexis, and a small fraction of the Lexis/Nexis sales proceeds are therefore subject to Illinois tax.

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[11] Although Mead argued below that the annual report and SEC filing should not be considered, the Illinois Appellate Court noted that Mead had identified no authority in support of this proposition. Pet. App. 13a. Indeed, this Court long has relied on annual reports in its decisions evaluating income apportionability. See *Container Corp.*, 463 U.S. at 180 n.19; *Woolworth*, 458 U.S. at 369.

As noted above (at p. 19), the concept of a unitary business "is not, so to speak, unitary." *Container Corp.*, 463 U.S. at 167. Ignoring formal distinctions between business units, see, *e.g.*, *Mobil Oil*, 445 U.S. at 440-41, this Court has described a "unitary" business variously as one having "functional integration, centralization of management, and economies of scale," *Exxon Corp. v. Wis. Dep't of Revenue*, 447 U.S. 207, 222 (1980) (citing *Mobil Oil*, 445 U.S. at 438); one in which the different arms of the business exhibit "substantial mutual interdependence," *Woolworth*, 458 U.S. at 371; and as an "organic system" in which out-of-state assets add value to the property and rights within the taxing state, *Bass, Ratcliff & Gretton v. State Tax Comm'n*, 266 U.S. 271, 280-82 (1924). Broadly speaking, a unitary business involves a "sharing or exchange of value" between a business' in and out-of-state activities "not capable of precise identification or measurement—beyond the mere flow of funds arising out of a passive investment or distinct business operation—which renders formula apportionment a reasonable method of taxation." *Container Corp.*, 463 U.S. at 166.

The "operational function" standard is a corollary to the unitary business test, for both inquiries ask whether income "was earned in the course of activities []related to those carried out in the taxing State." *Allied-Signal*, 504 U.S. at 787 (internal punctuation omitted); 1 Jerome Hellerstein & Walter Hellerstein, State Taxation, 8-95 to 8-96 n.426 (Warren, Gorham & Lamont 3d ed. 2000) [hereinafter *State Taxation*] (noting that "both tests are corollaries of the broad proposition that 'the linchpin of apportionablity * * * is

the unitary business principle'") (quoting *Mobil Oil.*, 445 U.S. at 439); accord Tax Executive Institute ("TEI") Br. 10 (operational function test is "gloss" on unitary principle).

The two doctrines call for slightly different inquiries, however. Whereas the business unity test turns on factors such as synergies, economies of scale, and overlapping personnel, the operational function test "focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State." *Allied-Signal*, 504 U.S. at 785 (citing *Container Corp.*, 463 U.S. at 180 n.19); see also *Allied-Signal*, 504 U.S. at 787. Commentators have clarified this distinction: "The essential question under the operational-function test is whether the intangible asset is part of the corporate taxpayer's *own* unitary business, not whether two separate corporations are engaged in a common enterprise." *State Taxation*, at 8-95 to 8-96 n.426 (emphasis in original); see also Walter Hellerstein, *State Taxation of Corporate Income from Intangibles:* Allied-Signal *& Beyond*, 48 Tax L. Rev. 739, 791 (1993) [hereinafter Allied-Signal *& Beyond*]. Thus, while the same facts may evidence both business unity and an operational function, see *State Taxation*, at 8-95 to 8-96 n.426, in identifying an operational asset, this Court looks specifically for objective evidence of management's role in ensuring the asset's growth and at the asset's role in the taxpayer's business operations in the taxing state. See *Allied Signal,* 504 U.S. at 785; *Container Corp.*, 463 U.S. at 180 n.19; see also *ASARCO*, 458 U.S. at 323.

In the end, the constitutional question ultimately hinges on what Mead *actually* contributed to Lexis/Nexis's Illinois operations and what Lexis/Nexis *actually* contributed to Mead's Illinois operations. See *Allied-Signal*, 504 U.S. at 787-88; *Container Corp.*, 463 U.S. at 178-79; *Woolworth*, 468 U.S. at 371-72. The facts demonstrate that those contributions were substantial and—under either doctrine—supported the Illinois courts' finding that the gain was apportionable.

1. Mead and Lexis/Nexis Were a Unitary Business.

Mead and Lexis/Nexis operated as a unitary business, as this Court's decision in *Container Corporation* demonstrates. Container Corporation ("Container") was a Delaware corporation, doing business in California and elsewhere, with foreign subsidiaries operating abroad. See 463 U.S. at 163. Container held a controlling interest in each subsidiary; it sold products to the subsidiaries, but only in an amount equal to "about 1% of the subsidiaries' total purchases"; "[t]he subsidiaries were * * * relatively autonomous with respect to matters of personnel and day-to-day management," which were "left in the hands of local executives"; "[t]here was no formal United States training program for the subsidiaries' employees"; and "[a]lthough local decisions regarding capital expenditures were subject to review by [Container], problems were generally worked out by consensus rather than outright domination." *Id.* at 171-72. Notwithstanding these facts, this Court applied unitary business principles to uphold California's tax on a share of the gain realized

by Container's offshore subsidiaries. Critically, the Court reached this conclusion for reasons that apply equally here.

In particular, the Court found it material that Container assisted "its subsidiaries in obtaining used and new equipment." 463 U.S. at 179. Mead's involvement in Lexis/Nexis's procurement efforts was far more extensive. It supervised Lexis/Nexis's important acquisition decisions and helped to implement those decisions once made. J.A. 133. In one instance, Mead leased $7.67 million central processing units for Lexis/Nexis's use. *Id.* at 132-33.

In *Container Corporation*, the Court cited the fact that Container "loan[ed] funds to the subsidiaries and guarantee[d] loans provided by others" to promote the subsidiaries' growth and profitability. 463 U.S. at 179, 180 n.19. Mead was far more actively involved in promoting Lexis/Nexis's financial success. Before Lexis/Nexis became profitable, Mead gave (not loaned) money to Lexis/Nexis, J.A. 169, and Mead collected and invested Lexis/Nexis's excess cash using Mead's own banking relationships, J.A. 180-81. Such economies of scale are emblematic of a unitary business. See *Container Corp.*, 463 U.S. at 179, 180 n.19.

Mead's amici emphasize that the nightly cash sweep is not evidence of a flow of value between Mead and Lexis/Nexis. See Gannett Br. 11-13; COST Br. 15; Disney Br. 15-16. But the point is not that Mead and Lexis/Nexis commingled funds, as the amici suggest; it is that Mead performed a valuable task on Lexis/Nexis's behalf, at no cost to Lexis/Nexis, and

therefore went well beyond the role of a passive investor. See *Container Corp.*, 463 U.S. at 180 n.19; cf. *Woolworth*, 458 U.S. at 364 n.11 (mere commingling of subsidiary's dividends with corporate funds did not in and of itself show that discretely operated businesses were unitary).

In addition, the Court in *Container Corporation* cited the taxpayer's "technical assistance" to its subsidiaries, coupled with the "supervisory role played by [Container's] officers in providing general guidance to the subsidiaries." 463 U.S. at 179. Mead provided substantial guidance and advice to Lexis/Nexis. In many instances, Mead's managerial role went beyond the "technical" and "advisory," as when Mead funded, executed, or approved contracts on Lexis/Nexis's behalf. J.A. 141, 144; see *Container Corp.*, 463 U.S. at 173 n.9 (finding it significant that, "[i]n at least one instance, appellant became involved in the actual negotiation of a contract between a customer and a foreign subsidiary"). Moreover, on top of its role in reviewing Lexis/Nexis's business plan and managing Lexis/Nexis's more significant expenditures, Mead infused Lexis/Nexis with Mead's own management principles, exemplified by the company-wide "three key initiatives" program, which Lexis/Nexis dutifully implemented. J.A. 60-63.

Accordingly, Mead and its amici mischaracterize the record when they say that Mead merely "kept track of" Lexis/Nexis's performance as any "prudent investor" would or, alternatively, engaged in nothing more than limited strategic decision-making. See, *e.g.*, Pet. Br. 34-35; COST Br. 11-17; Disney Br. 18-20.

Moreover, Mead points to its supposed lack of day-to-day management over Lexis/Nexis, Pet. Br. 8-10, but the same lack of day-to-day management was true of Container's relationship with its overseas subsidiaries, see 463 U.S. at 172, and the Court not only found a unitary relationship in that case, but also emphasized that "mere decentralization of day-to-day management responsibility and accountability cannot defeat a unitary business finding," *id.* at 180 n.19. Indeed, Mead's arrangement with Lexis/Nexis was characteristic of Mead's relationship with every one of its business segments, even those that were unquestionably part of its unitary business. They were all largely left to run themselves. Record Vol. 9, RP 109, 111-12; J.A. 127, 163-64. Thus, the presence or absence of day-to-day management is never dispositive. What matters is "whether the management role that the parent does play is grounded in its own operational expertise and its overall operational strategy." *Container Corp.*, 463 U.S. at 180 n.19. Container satisfied this standard by sharing "business 'guidelines'" with its subsidiaries, managing by consensus, and furnishing some "uncompensated technical assistance." *Id.* Mead did so with involvement in decisions on significant expenditures, contract work on Lexis/Nexis's behalf, and programs like "key initiatives."

To be sure, this case is not factually identical to *Container Corporation.* Thus, for example, the taxpayer in that case was engaged in the same basic line of business as its subsidiaries. 463 U.S. at 172. But this distinction is immaterial. Indeed, the Court emphasized the relative insignificance of this fact and

observed that it was of "limited use" to the California court in upholding the tax. *Id.* at 178. In other respects, moreover, the differences between *Container Corporation* and this case demonstrate a far greater "flow of value"—the loadstar of the unitary business inquiry, see *id.*—between Mead and Lexis/Nexis than existed between Container and its subsidiaries. Beyond the value that Mead imparted to Lexis/Nexis, in the form of capital infusions and free money management, Mead derived substantial value from Lexis/Nexis. Mead used Lexis/Nexis to obtain more than $680 million in tax deductions over five years (in Illinois alone) and admitted to manipulating Lexis/Nexis's corporate form repeatedly to capitalize on additional millions of dollars in tax savings. J.A. 14, 130-31, 134-35, 147, 149.

Mead also held itself out to the government, its investors, and the public broadly as a leader in electronic publishing, and filed unitary tax returns in combination with Lexis/Nexis. Record Vol. 4, C849, C856-68; J.A. 59, 92-100, 102, 104, 120-21, 126. The finding of a unitary business in *Container Corporation*, where many of these additional facts were absent, compels the same finding in this case.

Woolworth, *ASARCO*, and *Allied-Signal* are not to the contrary, for the relationship between Mead and Lexis/Nexis is readily distinguished from the passive investments found to exist in those cases. See generally *Container Corp.*, 463 U.S. at 179 (distinguishing *ASARCO* and *Woolworth*). In *Woolworth*, for instance, "*no* phase" of the taxpayer and subsidiary businesses was interrelated. 458 U.S. at

365 (emphasis in original). The Court found it relevant that each subsidiary in that case was responsible for obtaining its own financing, see *id.* at 366; Woolworth had no training program to impart its retail philosophy to its subsidiaries, and no corporate department to oversee the subsidiaries' operations, see *id.* at 366-67; and Woolworth and its subsidiaries did not file consolidated tax returns, see *id.* at 368. Corporate oversight in that case was limited to deciding on dividends, approving substantial debt, and including consolidated financial statements in the annual report. See *id.* at 368-69. In contrast, Lexis/Nexis relied on Mead for financing, J.A. 154-55, 169; Mead imposed its management program on Lexis/Nexis, J.A. 60-63; a Mead corporate committee oversaw Lexis/Nexis's growth, J.A. 132; and Mead and Lexis/Nexis filed combined unitary Illinois tax returns, Record Vol. 4, C849.

Allied-Signal and *ASARCO* are likewise inapposite. In these cases, the taxpayer either was a minority shareholder and thus lacked a controlling interest, see *Allied-Signal*, 504 U.S. at 788 (20.6% interest); *ASARCO*, 458 U.S. at 323-24 (34% and 49% interests); had voluntarily relinquished control, see *ASARCO*, 458 U.S. at 321-22; or had stipulated that the businesses had no connection with each other, see *Allied-Signal*, 504 U.S. at 774. Mead, by contrast, not only had a controlling interest in Lexis/Nexis, but exercised its control in the myriad ways previously described.

In sum, Mead and Lexis/Nexis operated as a unitary business, and although this issue was not

reached below, it provides an independent basis to affirm the judgment of the Illinois Appellate Court.

2. Lexis/Nexis Was an Operational Asset of Mead.

In the alternative, if this Court were to conclude that Mead and Lexis/Nexis did not operate as a unitary business, the Illinois Appellate Court's decision should be affirmed because that court correctly concluded that Lexis/Nexis was Mead's operational asset. Pet. App. 14a. In particular, the court noted that Mead owned 100% of Lexis/Nexis and, critically, determined that while "Mead did not have day-to-day control over Lexis/Nexis, its involvement with Lexis/Nexis was more than merely passive." *Id.* at 13a. The court supported this conclusion with a number of specific findings: Mead contributed capital to Lexis/Nexis, approved major expenditures, manipulated Lexis/Nexis's corporate structure for Mead's advantage, appropriated its tax benefits, and exercised control over its excess cash. *Id.* at 12a-13a. Moreover, Mead's annual report and SEC filing showed that Mead considered itself to be in the electronic publishing business, and viewed Lexis/Nexis as a business segment rather than an investee. *Id.* at 13a. The lower court's conclusion that Lexis/Nexis was an operational asset rather than a passive investment was correct, and at the very least falls well "within the realm of permissible judgment," the standard by which this Court reviews this determination. *Container Corp.*, 463 U.S. at 180 (internal quotation marks omitted).

Of the facts on which the appellate court relied, one alone is likely sufficient to show that Lexis/Nexis was an operational asset, rather than a passive investment (and this fact certainly suffices in combination with the others on which the court relied)—Mead regularly manipulated Lexis/Nexis's corporate form to obtain valuable tax savings, capturing Lexis/Nexis's loss carryforwards. Mead bore the burden of proof at trial, yet nothing in the record suggests that Mead's acquisition of these carry forwards and other tax benefits worth millions of dollars occurred at arm's length. To the contrary, Mead paid only $350,000 to effect its latest merger with Lexis/Nexis, in 1993, in exchange for millions of dollars in "estimated annual savings." J.A. 147. Such actions go well beyond what a passive investor could do.

Mead and its amici downplay Mead's manipulation of Lexis/Nexis, see, *e.g.*, Pet. Br. 38-39; COST Br. 14, but what Mead did is no different than purchasing paper or other products from Lexis/Nexis at below-market rates. Using its Lexis/Nexis division to secure below-cost tax savings for itself just as surely serves "an operational rather than an investment function." *Allied-Signal*, 504 U.S. at 787.

Mead's only hope is to characterize this Court's "operational function" language in *Allied-Signal* as an insignificant gloss on, or "narrow exception" to, the unitary business doctrine, and elsewhere to argue that any fact tending to show a unitary business is immaterial to the operational function analysis. Pet. Br. 25, 36-41 (emphasis omitted); see also Gannet Br.

6; Disney Br. 10, 12-14; COST Br. 8-9. But neither of these views square with *Allied-Signal* itself.

First, *Allied-Signal* makes clear that the "operational function" test is not limited to one or two narrow exceptions, as Mead contends. The Court did suggest examples of an operational relationship—interest on short-term deposits in out-of-state banks, where the interest is used as working capital, and the investment in *Corn Prods. Refining Co. v. Comm'r*, 350 U.S. 46 (1955), which ensured a supply of a producer's key ingredient, *Allied-Signal*, 504 U.S. at 787-88—but these illustrations were not exclusive. The court made clear that the first was merely an "example," and referred to *Corn Products* only in passing. *Id.* at 787-88; accord *State Taxation*, at S8-7 (2006 Supp.) ("Although the Court in *Allied-Signal* gave two examples of investments that served an operational function, there was no suggestion that those examples were exclusive.").[12] The ultimate question remains whether the taxpayer can "prove that the income was earned in the course of activities unrelated to [those carried out in the taxing] State," *Allied-Signal*, 504 U.S. at 787 (internal quotation marks omitted) (alterations in original), and courts

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[12] Mead purports to add two more examples: "'loan and loan guarantees' that support 'operations' in the same line of work as the unitary business," Pet. Br. 30 (citing *Container Corp.*, 463 U.S. at 180 n.19), and "nonunitary 'stock investments'" which have been "'accumulated for the future operation'" of the taxpayers' "'own primary business,'" *id.* at 31 (citing *ASARCO*, 458 U.S. at 324 n.21). Mead thereby implicitly rejects its own argument, made in its Petition for Certiorari (at p. 16), that the operational function test is limited to the two examples mentioned in *Allied-Signal*.

may consider any fact material to that ultimate inquiry.

Certainly, the view that no operational relationship may be found between two different lines of business, see Gannett Br. 17-18, is incorrect. Indeed, such a rule would encourage the sort of corporate manipulation that apportionment was designed to prevent. See *Mobil Oil*, 445 U.S. at 440-41. This is because the more a multistate corporation diversified, the less likely the corporation would be taxable in any State, because it would always be able to claim that it was merely a passive investor in subsidiaries that undertake different lines of business. As we have explained (see *supra* p. 18-19), apportionment is intended to ensure that a State receives a just return for the benefits and opportunities it has conferred on in-state business activity. Apportionment has nothing to do with the form a business organization takes.

Second, far from holding that facts must be assigned rigidly either to the "unitary business" or to the "operational function" inquiry, *Allied-Signal* makes plain that the two standards are related means of distinguishing income-generating assets that perform mere investment functions from those that are operational. See 504 U.S. at 785, 787. Thus, the two approaches to constitutional apportionment are, as explained above (see *supra* pp. 32-33), corollaries of the constitutional nexus requirement rather than wholly distinct lines of analysis. See *State Taxation*, 8-95 to 8-96 n.426. Therefore, contrary to Mead's repeated suggestions, see Pet. Br. 36-41; see also COST Br. 12-

13, it was perfectly proper for the Illinois Appellate Court to support its "operational function" finding with facts that would also tend to show a unitary business. Moreover, Mead's effort to divide the facts between the unitary business and operational function inquiries ignores that the facts in combination are what demonstrate whether the constitutional test was met, regardless of whether any one fact alone shows the requisite constitutional link. See *Container Corp.*, 463 U.S. at 179-80. Thus, Mead's view that this Court should limit its analysis to the flow of benefits from Lexis/Nexis to Mead, and should not consider the benefits that flowed from Mead to Lexis/Nexis, see Pet. Br. 33-34, finds no support in the caselaw. Because the unitary business and operational function tests are not mutually exclusive, both types of evidence may and should be considered when evaluating operational purpose.

Finally, although Mead relies heavily on *Allied-Signal*, see Pet. Br. 30-36, that reliance is misplaced. The taxpayer there owned only 20.6% of its investee's stock and had no way to control the investee; moreover, the parties had stipulated that each business "had nothing to do with the other." See 504 U.S. at 788. In contrast, Mead owned all of Lexis/Nexis. More important, at the time of sale Lexis/Nexis was a *division* of Mead, not a subsidiary; as such, Mead both could and did control its business operations.

That being said, we do not claim that ownership is a sufficient condition to show an operational function. Indeed, Mead and its amici mischaracterize the Illinois Appellate Court's decision as relying entirely on Mead's

100% ownership of Lexis/Nexis. See Pet. Br. 38, 49-50; Disney Br. 14; TEI Br. 12. To the contrary, Mead's sole ownership of Lexis/Nexis was merely one of the factors the court considered. Pet. App. 12a-13a.[13] Crucially, the court based its finding of operational purpose on its recognition that Mead *exercised control over* Lexis/Nexis in myriad ways and held itself out to the world as an electronic publisher rather than a mere investor in Lexis/Nexis. *Id.* at 13a. But it cannot be denied that the ability to control a business is a necessary condition of showing actual control, and thus the court properly cited Mead's 100% ownership of Lexis/Nexis as relevant. See *Container Corp.*, 463 U.S. at 177 n.16 (noting that ability to control is relevant but not dispositive of unitary analysis) (citing *Woolworth*, 458 U.S. at 362).

In sum, Mead has failed to carry its burden of proving clearly and cogently that Illinois is taxing extraterritorially, or to show that the Illinois Appellate Court's decision is outside "the realm of permissible judgment," *Container Corp.*, 463 U.S. at 176, in holding that Lexis/Nexis was an operational asset of Mead.

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[13] Because the Illinois Appellate Court did not equate ownership with apportionability, sustaining that court's decision will not, as Mead argues, see Pet. Br. 49-50, run afoul of "apportionment formulae that have been in place for more than 50 years," *id.* at 49, or otherwise result in misattribution of income.

C. Even If Mead Were A Passive Investor In Lexis/Nexis, Illinois Acted Properly, For The State Taxed Only That Portion Of Mead's Gain Reflecting Lexis/Nexis's Illinois Activities.

As we explain, under no fair reading of the facts was Mead merely a passive investor in Lexis/Nexis. To the contrary, because the control Mead exercised was such that it essentially operated Lexis/Nexis in Illinois, or at the very least had a unitary or operational relationship with Lexis/Nexis, there was no error in the lower courts' determination that Illinois's tax was proper. That said, even if, as Mead urges, Lexis/Nexis is viewed purely as a passive investment, that would not change the outcome of this case. To the contrary, it is well settled that a State may tax the income an out-of-state corporation derives from its investment in another out-of-state corporation where, as here, the tax fairly reflects the benefits and protections the State has provided the investee.

This follows from the established principle that a State has the power to tax income earned within its borders. See *Int'l Harvester*, 322 U.S. at 441; *J.C. Penney*, 311 U.S. at 446. As the Court has explained,

> [a] state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation and which are within the protection of

> the state and entitled to the numerous benefits which it confers.

Int'l Harvester, 322 U.S. at 441-42. A tax based on the investee's in-state earnings fairly reflects the benefits, protections, and opportunities provided by the taxing State. See *id.* at 444 ("the incidence of the tax as well as its measure is tied to the earnings which the [State] has made possible"); *J.C. Penney*, 311 U.S. at 444 ("The simple but controlling question is whether the state has given anything for which it can ask return."); see also *Bridges v. Autozone Prop., Inc.*, 900 So. 2d 784, 809 (La. 2005); *Geoffrey, Inc. v. S.C. Tax Comm'n*, 437 S.E.2d 13, 18 (S.C. 1993).

Applying this principle in *International Harvester*, this Court held that Wisconsin could tax nonresident shareholders on dividends issued by a nondomiciliary corporation where the dividend amounts subject to the tax were fairly attributable to its Wisconsin earnings. See 322 U.S. at 442-43; see also *Allied-Signal Inc. v. Comm'r of Fin.*, 588 N.E.2d 731, 737-38 (N.Y. 1991) ("*Allied-Signal II*") (New York City could constitutionally tax nondomiciliary's investment income in another company that conducted business in city where income was apportioned based on investee's New York City attributes); accord Allied-Signal & *Beyond*, 48 Tax L. Rev. at 817-18 (noting with approval holding of *Allied-Signal II* that "a state may tax the income derived from a nondomiciliary corporation from its investment in another corporation if the state has provided benefits and protections to other such corporation").

Thus, even if Lexis/Nexis was nothing more than a passive investment for Mead, Illinois could properly tax the gain Mead realized from the sale of Lexis/Nexis, so long as Illinois limited its taxation to the fraction of the gain that was attributable to Lexis/Nexis's activities in Illinois. That is exactly what happened here.

Illinois assessed a tax on the gain in the goodwill value of Lexis/Nexis's business. J.A. 5-6, 26, 55; Record Vol. 9, RP 228. "Goodwill" is defined as "'that element of value which inheres in the fixed and favorable consideration of customers, arising from an established and well-known and well-conducted business.'" *Newark Morning Ledger v. United States*, 507 U.S. 546, 555 (1993) (quoting *Des Moines Gas Co. v. Des Moines*, 238 U.S. 153, 165 (1915)). As such, goodwill arises from "'the general public patronage and encouragement'" a business "'receives from constant or habitual customers on account of its local position, or common celebrity, or reputation for skill or affluence, or punctuality * * *.'" *United States v. Winstar Corp.*, 518 U.S. 839, 849 n.5 (1996) (quoting J. Story, Partnerships § 99 (1841)). As these definitions make plain, the goodwill value of an enterprise is directly associated with any State in which the enterprise does business. That is, by providing the orderly society in which Lexis/Nexis conducted its business, Illinois made it possible for Lexis/Nexis to accrue goodwill.

Because Illinois helped to create the income at issue here, Illinois should not be prevented from assessing a tax on its constitutionally permissible share of that income. Significantly, Illinois sought to

tax no more than that portion of Lexis/Nexis's goodwill that was generated within its borders. In apportioning the Lexis/Nexis gain to Illinois, the Department included only $40.6 million of the $1.05 billion gain to Mead in the apportionment factors. J.A. 5. The $40.6 million attributable as Illinois earnings, which amounted to less than 4% of the total gain, was calculated using only Lexis/Nexis's own Illinois factors. J.A. 55, 186.[14] Thus, the record shows that the Department's apportioned share fairly reflects those values that contributed to the goodwill realized from Lexis/Nexis's Illinois activities.

Because Illinois sought to apportion only the share of the Lexis/Nexis gain actually attributable to Illinois, the State was exercising its taxing powers to capture only the income earned in Illinois. That does not violate the Constitution. See *Int'l Harvester*, 322 U.S. at 443-44; see also *Allied-Signal II*, 588 N.E.2d at 737-38. Moreover, if Mead believed that Illinois's approach did not fairly reflect *Lexis/Nexis*'s in-state earnings, Mead could have petitioned the Director of the Department for alternative apportionment under 35 ILCS 5/304(f) (1994). However, as the appellate court recognized, Pet. App. 17a, Mead brought no such petition.

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[14] In fact, Lexis/Nexis's average apportionment percentage of 3.7%, J.A. 189, was remarkably close to Mead's average apportionment percentage of 4.1%, J.A. 28.

III. Mead's Policy Arguments Do Not Persuade.

For the foregoing reasons, the Constitution permits Illinois to tax a portion of the gain from Mead's sale of Lexis/Nexis. Nevertheless, Mead and its amici advance several policy rationales that they believe warrant imposing additional limitations on Illinois's ability to impose the tax at issue. We address these arguments in turn.

A. There Is No Threat Of Prohibited Multiple Taxation.

First, Mead and its amici raise the specter of prohibited multiple taxation if even a fraction of Mead's gain from the sale of Lexis/Nexis is subject to Illinois tax. See Pet. Br. 50-53; COST Br. 17; Disney Br. 26; TEI Br. 17. According to this view, because Mead is domiciled in Ohio, and Ohio, at least theoretically, has the authority to tax the gain in its entirety, the Constitution does not permit any other State to tax any portion of that gain, regardless of the extent to which Lexis/Nexis did business in that State.

We may quickly put aside any claim of multiple taxation in this case. Mead has never presented any evidence that it will be subject to multiple taxation if the Illinois Appellate Court's decision is upheld. To the contrary, Mead implicitly concedes that Ohio has not taxed the entire gain and, thus, that no multiple taxation will occur. See Pet. Br. 53 n.13 ("That Ohio's tax code may not actually tax the entire transaction is of no consequence."). Indeed, it is highly probable that Ohio has not taxed the entirety of the gain. This is because under the apportionment principles in effect in

Ohio in 1994—which are similar to Illinois's apportionment principles—Ohio likely would have characterized the gain as apportionable business income because it was reinvested back into Mead's business. See, *e.g.*, *Kemppel v. Zaino*, 746 N.E.2d 1073, 1075 (Ohio 2001). Accordingly, at most, Ohio would have apportioned a fraction of the gain, rather than allocate the entire gain to itself. The result is that "actual multiple taxation is not demonstrated on this record." *Mobil Oil*, 445 U.S. at 444. In its challenge to alleged multiple taxation, therefore, Mead does not "seek[] relief from a present tax burden"; at best, it "seeks to establish a theoretical constitutional preference for one method of taxation over another." *Id.*

In any event, even if Mead could show duplicative taxation in this case, this Court squarely held in *Mobil Oil* that multiple taxation under circumstances analogous to these does not contravene the Constitution. In *Mobil Oil*, the taxpayer, a New York domiciliary, claimed that because New York had the power to tax all of its dividend income without apportionment, the Commerce Clause did not permit Vermont to tax even an apportioned share of that income. See 445 U.S. at 443-44. This Court flatly rejected the argument. As the Court explained, the law recognizes no preference for allocation over apportionment. See *id.* at 444-45. Furthermore, "the constitutionality of a Vermont tax should not depend on the vagaries of New York tax policy." *Id.* at 444. Rather, because the dividends reflected income of a business conducted in several States, including Vermont, the income "b[ore] relations to the benefits

and privileges conferred by [those] states." *Id.* at 446. As a result, Vermont could properly tax its proportionate share of that income. See *id.* Thus, whatever power New York had to reach the taxpayer's income, such power was not exclusive when the income in question arose from the operation of the taxpayer's business conducted partly in Vermont. See *id.* at 445-46.

Just so here. Because the requirement of a minimal nexus between Illinois and the activities giving rise to Lexis/Nexis's gain is more than adequately met, the fact that Ohio also may have a right to tax this income does not render Illinois's apportionment of that same income unconstitutional. See *Mobil Oil*, 445 U.S. at 445-46; see also *State Taxation*, at 6-13 (recognizing constitutional preference for apportionment by income source State when its powers conflict with those of State of residency); William D. Dexter, *Tax Apportioment of the Income of a Unitary Business: An Examination of* Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 1981 BYU L. Rev. 107, 130 (1981) (same).

Thus, Mead's reliance on *Cent. Greyhound Lines, Inc. v. Mealy*, 334 U.S. 653 (1948), is misplaced. In *Central Greyhound*, the Court invalidated an unapportioned gross receipts tax on interstate travel because "[b]y its very nature" the tax at issue "ma[de] interstate transportation bear more than a fair share of the cost of the local government whose protection it enjoys." *Id.* at 663 (citation and internal quotation marks omitted). That is a far cry from this case, in which Illinois seeks to tax only its apportioned share of

the gain based on the percentage of business Lexis/Nexis conducted in Illinois. Moreover, even in *Central Greyhound*, the Court recognized that there would have been no constitutional problem had the tax been "fairly apportioned to the business done within the state by a fair method of apportionment." *Id.* (citation and internal quotation marks omitted). Thus, *Greyhound* supports rather than undermines Illinois's approach to taxation.

B. Allowing Illinois To Tax A Fraction Of The Gain Will Not Raise Transaction Costs For Multistate Corporations.

Second, Amicus Disney describes a doomsday scenario under which allowing taxation in this case may "hamper * * * economically beneficial merger and acquisition activity" by requiring multistate companies to suffer potentially negative tax consequences when acquiring a so-called "unwanted business"—that is, a business the purchaser has no intention of running but plans to hold as an investment until the market is ripe for sale—as part of a merger. Disney Br. 22-23.

This argument is wholly conjectural. The tax treatment of an acquisition depends on many facts—including some that are within the taxpayer's control, such as which entity realizes the gain, as well as the particular taxpayer's relationship to the specific business asset and activities in the taxing State. How these multiple factors will manifest themselves in any particular acquisition is entirely speculative.

In any case, Lexis/Nexis was hardly an "unwanted business." That is clear from the statement of Mead's CEO that the divestiture of Lexis/Nexis was "probably the toughest decision I've ever had to make." J.A. 42-44. Moreover, for the myriad reasons developed above, Lexis/Nexis was not a mere investment but was part of Mead's operating business. Disney's analogy to an "unwanted line of business," Disney Br. 23, is therefore inapplicable to this case.

C. Affirming The Illinois Appellate Court Will Not Upset Settled Expectations.

Finally, Mead and its amici advance the erroneous view that the decision of the Illinois Appellate Court in this case conflicts with the decisions of other state courts, see Pet. Br. 47-49, and, moreover, that sustaining that decision would "upset * * * decisions made in reliance on *Allied-Signal*," Disney Br. 25-26. As we explain above (see *supra* pp. 25 n.9, 39, 41-44), the decision below fully complies with *Allied-Signal*; accordingly, affirmance of that decision would not "repudiate" *Allied-Signal*, Disney Br. 25, much less amount to its "formal overruling," *id.* Indeed, the cases cited by Mead demonstrate that state courts have in large part aptly applied the *Allied-Signal* test, and there is nothing inconsistent in the Illinois court's application here.

For example, in *Hoechst Celanese Corp. v. Franchise Tax Bd.*, 22 P.3d 324 (Cal. 2001), the California Supreme Court found that the gain realized from a partial reversion of the taxpayer's pension trust fund was operational income, despite the fact that the

corporate taxpayer did not hold legal title to the trust fund assets. See *id.* at 328-30. The income was apportionable under the operational function test because the taxpayer funded the plan, oversaw the plan by choosing its management and guiding its overall investment strategy, and because the plan—by supporting the taxpayer's retention and recruitment efforts—made better use of the taxpayer's employees, a business-related resource. See *id.* at 344-45.

Thus, in reaching its conclusion that the trust fund was the taxpayer's operational asset, the *Hoechst Celanese* court relied on many of the same facts that the Illinois Appellate Court did—capital support, investment oversight and control, as well as that the asset freed up the taxpayer to make better use of existing business resources (a function here played by Mead's use of Lexis/Nexis's net loss carryforwards and other tax deductions). Indeed, while Mead describes *Hoechst Celanese* as "confin[ing] the operational function test to the two circumstances previously articulated by this Court," Pet. Br. 48, this is incorrect. *Hoechst Celanese* recognized, as did the appellate court here, that the operational function inquiry is not a narrow exception to the unitary business test, but a corollary to that test that considers many of the same factors.

Alaska Dep't of Revenue v. OSG Bulk Ships, Inc., 961 P.2d 399 (Alaska 1998), and *Pennzoil Co. v. Dep't of Revenue*, 33 P.3d 314 (Or. 2001), similarly do not support Mead's contention, see Pet. Br. 48, that the operational function inquiry is but a limited exception to the unitary business test. Neither of these cases

involved a capital transaction, and thus both are distinguishable on their facts from the instant case. And, in any event, neither case supports the narrow view of the operational function test that Mead advocates. Indeed, in *OSG Bulk Ships*, the court specifically noted that the two circumstances described in *Allied-Signal* were mere "examples" of the "fact intensive" operational function test. 961 P.2d at 413. And although the court found that the income at issue was not apportionable pursuant to that test, the court remanded for a determination on the applicability of the unitary business test. See *id.* at 414. As for *Pennzoil*, the court there found that the disputed income was apportionable under the *Corn Products* doctrine, see 33 P.3d at 318, which of course is one of the two circumstances *Allied-Signal* expressly anticipated as an example of an operational function. See *supra* p. 42. That the *Pennzoil* court found the operational function test satisfied under these circumstances in no way suggests that the court believed the test should be limited to the examples this Court provided in *Allied-Signal*.

Finally, as for the series of *Hercules* cases, also cited by Mead, see Pet. Br. 47-48, they, too, do not suggest a different result than the Illinois Appellate Court reached here. This is because the holdings in *Hercules* that there existed no unitary or operational relationship were based on factual findings that the taxpayer either could not or did not control the asset at issue. See *Hercules Inc. v. Comptroller of Treasury*, 716 A.2d 276, 281 (Md. 1998); *Hercules Inc. v. Comm'r of Revenue*, 575 N.W.2d 111, 116-17 (Minn. 1998); see also *Hercules, Inc. v. Dep't of Revenue*, 753 N.E.2d 418,

426 (Ill. App. Ct. 2001). Here, by contrast, Mead exercised its control over Lexis/Nexis in myriad ways.[15]

And, in any event, the *Hercules* trio has been criticized as "taking too narrow a view of the 'operational function' concept." *State Taxation*, at S8-7. Thus, the academic scholarship recognizes that correct application of *Allied-Signal* dictates that any gain realized from the sale of a subsidiary, over which the taxpayer had considerable control and with which it dealt regularly, should be constitutionally apportionable. See *id.*

[15] Mead contends that the Department's motion to publish the unpublished order originally issued by the Illinois Appellate Court in the present case is a concession that the order departed from the law set forth in *Hercules*. See Pet. Br. 37 n.10. To the contrary, the motion distinguished the facts of this case from the facts of *Hercules*, Pet. App. 44a-45a, and argued that, as a result of these factual distinctions, the court's order "explain[ed] an existing rule of law," *id.* at 43a, thus making the order suitable for publication under Ill. Sup. Ct. R. 23(a)(1).

CONCLUSION

The judgment of the Appellate Court of Illinois should be affirmed.

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DECEMBER 3, 2007

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No. 06-1413 12-27-07

In The
Supreme Court of the United States

MEADWESTVACO CORPORATION, SUCCESSOR IN INTEREST TO THE MEAD CORPORATION,

Petitioner,

v.

ILLINOIS DEPARTMENT OF REVENUE, DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE, AND TREASURER OF THE STATE OF ILLINOIS,

Respondents.

On Writ Of Certiorari To The Appellate Court Of Illinois

REPLY BRIEF OF PETITIONER

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REPLY BRIEF OF PETITIONER

Mead paid taxes to Illinois, as a nondomiciliary corporation, based on the amount of Mead's income that was apportioned to its business conducted in Illinois. That taxation was based on the well-established proposition that a State can tax a corporation on its income attributable to business conducted within the taxing State. But respondents also required Mead to pay taxes based on a capital gain that was not apportionable to Illinois.

Respondents urge this Court to expand the reach of Illinois's tax authority and allow Illinois to include in Mead's apportionable tax base the capital gain derived by Mead from its out-of-state sale of its Lexis/Nexis investment. That capital gain, however, was earned by Mead in the course of activities unrelated to Mead's business conducted in Illinois. It was extraterritorial income not fairly attributed to the activities of the taxpayer Mead within the State. It was not income in the regular course of Mead's unitary business in Illinois, nor did it serve an operational function for that business.

This Court's precedents make clear that respondents cannot expand the reach of Illinois's taxing authority, consistent with the Due Process and Commerce Clauses, in such circumstances to allow the State to tax a nondomiciliary investor for a portion of a capital gain derived from the sale of a nonunitary investment.

I. RESPONDENTS' DEFENSE OF THE STATE COURT'S OPERATIONAL FUNCTION TEST IS MERITLESS

The sole justification of the state courts below for allowing Illinois to include in Mead's apportionable tax base the capital gain earned by Mead on the sale of Lexis/Nexis was that Mead's investment in Lexis/Nexis somehow served an operational function for Mead's paper and office supply business. But respondents devote only a small fraction of their brief to an attempt to defend that ruling. They rely on the single fact that Mead owned Lexis/Nexis and expected a return on that investment. That rationale does not meet the constitutional standard for operational function under *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992).

A. Respondents' Argument Is Contrary To *Allied-Signal*

Respondents are wrong that the state apportionment method of taxation is constitutional whenever the taxpayer corporation exerts some control over a nonunitary asset that produces out-of-state income or gain. Resp. Br. 40-45.

This Court has held that, unless there is a unitary business relationship between a taxpayer corporation and an asset in an out-of-state capital transaction, a State may tax an apportionment of the

gain derived from the asset *only if* that "capital transaction serve[s] an operational rather than an investment function" for the taxpayer's business conducted in the State. *Allied-Signal*, 504 U.S. at 787. In other words, the operational function test allows Illinois to tax an apportionment of Mead's capital gain on its sale of its Lexis/Nexis electronic data retrieval investment only if Lexis/Nexis was somehow used by Mead to serve an operational function for Mead's paper and office supply business conducted in Illinois. In the absence of such an operational relationship, the constitutionally required minimum connections between the State and the taxpayer's gain are not satisfied.

It is not enough that Mead's ownership of Lexis/Nexis affected Mead's balance sheet. *Allied-Signal* specifically cautioned that "the mere fact that an intangible asset was acquired pursuant to a long-term corporate strategy of acquisitions and dispositions does not convert an otherwise passive investment into an integral operational one." *Ibid.* And, a nonunitary asset does not become integral to the operations of a unitary business merely because that asset is "'acquired, managed or disposed of for purposes relating or contributing to the taxpayer's business.'" *Id.* at 789 (quoting *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 326 (1982)).

The *Allied-Signal* Court emphasized why this is so: "The business of a corporation requires that it earn money to continue operations and to provide a return on its invested capital. Consequently *all* of its

operations, including any investment made, in some sense can be said to be 'for purposes related to or contributing to the [corporation's] business.'" *Ibid.* The Court unequivocally rejected that unlimited concept as satisfying the constitutional standard. *Ibid.*

B. Respondents Cannot Prevail Based On The Standard Of Review Because The State Court Applied The Wrong Legal Standard For Operational Function

1. Respondents argue that the judgment below should be affirmed because the standard of review that this Court applies requires deference to state courts. Resp. Br. 40.[1]

No deference to a state court ruling is appropriate, however, where, as here, the court applied the wrong legal standard. This Court has made clear that first its "task must be to determine

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[1] Certain of respondents' *amici* also suggest that Mead's arguments before this Court shift the burden of proof to Illinois to prove its tax is constitutional. Br. of California et al. as *Amici Curiae* Supporting Respondents 28-30. Mead makes no such argument. Under the applicable standard, Mead has the burden of proof to demonstrate that the state tax was unconstitutional. But, as discussed in Mead's opening brief and in this reply, Mead fully met this burden through undisputed evidence. J.A. 10-13. It thus is incumbent upon respondents to rebut Mead's proffer or have its tax found unconstitutional.

whether the state court applied the correct standards to the case," and then, only if the state court did so, it must determine whether the state court's "judgment 'was within the realm of permissible judgment.'" *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 176 (1983) (quoting *Norton Co. v. Department of Revenue*, 340 U.S. 534, 538 (1951)). Thus, absent application of the correct legal standard by the court below, this Court does not owe deference to the state court judgment.

That is so here. The Illinois appellate court's judgment on operational function does not merit deference because that court applied the wrong legal standard. The court employed an ad hoc approach that cited some connections between the two businesses and some benefits they shared. The court rested its operational function ruling simply on Mead's ownership of Lexis/Nexis, Mead's occasional "involvement with Lexis/Nexis," and basic indicia of ownership. Pet. App. 12a-13a.

But the correct legal standard for operational function under *Allied-Signal* does not rest on such facts. *Allied-Signal* requires that a court look to whether Lexis/Nexis provided integral support to the operations of Mead's paper and office supply business conducted in Illinois. 504 U.S. at 789. And, as Mead's opening brief explains, the facts regarding the relationship between Mead's paper and office supply business and its Lexis/Nexis investment do not satisfy that test. Pet. Br. 30-41.

2. Respondents attempt to distinguish *Allied-Signal* on the ground that the taxpayer in that case "owned only 20.6% of its investee's stock and had no way to control the investee." Resp. Br. 44. But that fact was not relevant to the operational function inquiry in *Allied-Signal*. Rather, the Court cited the fact to support its conclusion that the taxpayer's minority stake in the investment meant that there was no possibility of "an integrated division of a single unitary business." *Allied-Signal*, 504 U.S. at 788. And even in the context of a unitary business relationship, this Court made clear that "potential control is not sufficient." *Ibid.* (citing *F.W. Woolworth Co. v. Taxation & Revenue Dep't*, 458 U.S. 354, 362 (1982)).[2]

3. Respondents also contend that the extent of its taxation of Mead can be justified because, they claim, "Mead regularly manipulated Lexis/Nexis's corporate form" to gain tax benefits. Resp. Br. 41. That post hoc justification based on corporate form is wrong for three reasons.

First, respondents' statement is belied by the facts to which respondents agreed through stipulation.

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[2] In *Woolworth*, for example, this Court invalidated an application of a state tax apportionment scheme even though three of the four subsidiaries the State sought to tax were 100% owned by the taxpaying parent. *Woolworth*, 458 U.S. at 356-357. Accordingly, not only does petitioner's 100% ownership have no relevance to the operational function test, it also is of limited probative value to the unitary business determination.

The stipulated record establishes that, in the twenty-six years during which Mead owned Lexis/Nexis, such a change occurred on only three occasions. J.A. 14. Far from demonstrating any "regular[]" manipulation of corporate form, those infrequent occurrences do not indicate that Lexis/Nexis somehow operationally supported Mead's paper and office supply business.[3]

Second, respondents' argument that the change in the corporate form of Lexis/Nexis was not "arm's length" (Resp. Br. 41) is nonsensical. Mead owned a 100% interest in Lexis/Nexis both before and after the change in corporate form. Moreover, the record does not support respondents' implication that there was a sale of Lexis/Nexis for $350,000; rather the record indicates that was the cost of effecting the corporate change. J.A. 147. The change in corporate form had no substantive effect on the operations at Lexis/Nexis vis-à-vis Mead. J.A. 165, 176-177.

Third, this Court has never placed significance on the corporate form of an asset but, instead, has focused on the activity of the asset to determine whether it served an operational function for the

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[3] Respondents' reliance on this fact also is undermined by their own insistence, starting in 1988, that Mead and Lexis/Nexis file consolidated tax returns in Illinois as a unitary business, which Mead did under protest. J.A. 13. Accordingly, the 1993 change in corporate form had no effect on Mead's taxes in Illinois, because Mead already was filing in that manner at the insistence of Illinois.

entity being taxed. *Cf. Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 440 (1980) ("the underlying activity, not * * * the form of investment * * * determine[s] the propriety of apportionability"). Respondents elsewhere concede as much. *See* Resp. Br. 43 ("Apportionment has nothing to do with the form a business organization takes.").

Respondents' *amici* make a somewhat similar argument, contending that Illinois can apportion to itself for taxing purposes part of the gain Mead received from the sale of Lexis/Nexis because the change in the form of Lexis/Nexis had "the purpose of setting off against the gains of one part of the business the losses incurred by another part." Br. of California et al. as *Amici Curiae* Supporting Respondents 31.[4] Their argument would eviscerate the operational function test. It would mean, as a practical matter, that a State would be entitled to increase its tax on a nondomiciliary corporation conducting a business in the State to include a variety of transactions involving the corporation's investments located in other States. That would be so whenever the corporation realized a tax benefit from its ownership of such out-of-state subsidiaries and

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[4] Neither Illinois nor its *amici* cite any case to support their extraordinary proposition that tax benefits that affect only a multistate corporation's balance sheet can serve an operational function. Our research has located only one case addressing that issue and it did so in the context of state law. *See Kewanee Indus., Inc. v. New Mexico*, 845 P.2d 1238 (N.M. 1993).

divisions even though those investments were not otherwise related to the corporation's unitary business conducted in the State. The practical and unsettling effect of such a result is explained in detail by *amicus curiae* in support of Mead's opening brief. *See* Br. of The Walt Disney Company as *Amicus Curiae* Supporting Petitioner 22-26; *see also* Pet. Br. 43-50.

C. Respondents Improperly Conflate The Operational Function Test And The Unitary Business Test

Respondents and their *amici* States confuse this Court's precedents when they claim that the operational function test is not distinct from the unitary business test, and is a mere component of the latter test. Resp. Br. 43-44; Br. of California et al. as *Amici Curiae* Supporting Respondents 14-21.

Significantly, this is a distinction without a difference, because such mislabeling cannot alter the fact that the state tax here fails under either approach. *See* pages 13-21 *infra* (unitary business); Pet. Br. 21-28 (same); *see* pages 4-9 *supra* (operational function); Pet. Br. 28-41 (same).

In any event, respondents' effort to blur the distinction between the two tests is misleading because, irrespective of whether the two tests are independent of one another or are components of a larger analysis, they each are distinct in that they measure in different ways the relationship between the taxpayer and the asset or investment that the

State seeks to tax. The unitary business test examines whether an asset is an integrated part of the taxpayer's business. The operational function test examines whether an asset that is not integrated with the taxpayer's business nonetheless provides integral operational support to the business.

By conflating the two tests, respondents seek to satisfy the operational function test based on evidence that shows no more than some economic connection between two businesses under common ownership. That evidence does not, as demonstrated above, meet the operational function test and, although it is probative it is not sufficient under the unitary business test.[5] Respondents appear to imply (Resp. Br. 44) that because, in their view, the two tests are not mutually exclusive, evidence of partial satisfaction of both tests can satisfy the constitutional standard, but that is clearly contrary to *Allied-Signal*.

Other than the court below, state courts have universally recognized that the operational function test is not satisfied merely because a nonunitary

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[5] We do not suggest that evidence probative of a unitary business relationship could not also be probative of an operational function. For example, it might be probative to both inquiries if the record demonstrated that the two businesses were in the same line of business. But what respondents ignore is that such evidence would be probative to both tests for different reasons, because of the different analyses each test employs.

asset contributes to a taxpayer's "financial strength overall," because to do so "would swallow the distinction between operational and investment income." *Alaska Dep't of Revenue v. OSG Bulk Ships, Inc.*, 961 P.2d 399, 411, 414 (Alaska 1998). State court decisions sustaining state apportionment under the operational function test share no similarities to the instant case. *Pennzoil Co. v. Department of Revenue*, 33 P.3d 314, 318 (Or. 2001), *cert. denied*, 535 U.S. 927 (2002) (agreement guaranteeing strategic petroleum resources for taxpayer petroleum business constitutes an operational function); *Hoechst Celanese Corp. v. Franchise Tax Bd.*, 22 P.3d 324, 345 (Cal.), *cert. denied*, 534 U.S. 1040 (2001) (trust and pension plan served an operational function because it was designed "to induce [the taxpayer's] current employees to stay and to attract new employees").[6] Taxation of the nonunitary asset's income or gain is justified in those cases because the income or value derived therefrom is used in an ongoing, integral operational capacity by the taxpayer's unitary business conducted in the taxing state.

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[6] *Allied-Signal* and state courts applying the operational function test also rebut respondents' claim (Resp. Br. 44) that the "flow of benefits" from Mead to Lexis/Nexis is relevant to the test. None of those cases describe a circumstance in which the operational function test would be satisfied due to a taxpayer's support of its nonunitary asset. Thus, it is respondents' argument that "finds no support in the caselaw." *Ibid.*

Respondents are wrong to challenge the fact that the operational function test is a narrow exception to the unitary business principle's limit on State taxation of out-of-state income. Resp. Br. 41-42. The narrow scope of the operational function test is demonstrated by the very limited circumstances in which it can sustain a state tax apportionment scheme. As Illinois concedes, this Court in *Allied-Signal* proffered just two examples: "interest on short-term deposits in out-of-state banks, where the interest is used as working capital"; and an investment "which ensured a supply of a producer's key ingredient." Resp. Br. 42.[7]

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[7] It was not until 1992, in *Allied-Signal*, that the Court applied, for its first and only time, the operational function test. The Court in *Container Corporation of America v. Franchise Tax Board* had articulated, but had not applied, the operational function test by citing an example where it might be satisfied based upon a case arising "in another context." 463 U.S. 159, 180 n.19 (1983). Other cases from that era challenging state tax apportionment methods were all resolved based on whether a unitary business relationship existed. *See ASARCO*, 458 U.S. 307; *Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207 (1980); *Woolworth*, 458 U.S. 354.

By contrast, this Court first set forth the unitary business test more than one hundred years ago. The Court allowed States to treat railroads that traversed several jurisdictions "as a unit" for tax purposes and then to apportion the value of that multistate "unit" to individual States. *State R.R. Tax Cases v. Kidder*, 92 U.S. 575, 608 (1875). This was so because the various components of the railroad present in each jurisdiction did not, in isolation, possess significant value. It was only by allowing States to consider the components in the various jurisdictions in the aggregate that the true value of the railroad as a whole

(Continued on following page)

II. RESPONDENTS' CHALLENGE TO THE TRIAL COURT'S UNITARY BUSINESS RULING FAILS

A. The Trial Court Correctly Concluded That There Was No Unitary Business Relationship Between Mead And Lexis/Nexis

Respondents argue that the trial court erred when it ruled that there was no unitary relationship between Mead and Lexis/Nexis. Resp. Br. 34-40. Although the Illinois appellate court declined to reach the issue, Pet. App. 11a, the trial court thoroughly examined the question and unequivocally and correctly resolved it in Mead's favor, Pet. App. 39a.[8]

As already noted above, and as Illinois acknowledges (Resp. Br. 40), this Court "will, if

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could be discerned and a State could tax a fairly apportioned part of it. *Ibid.*; *Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194 (1897); *see also Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 120 (1920) (upholding against constitutional challenge state apportionment method because "the profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sales in other states"); *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271, 282 (1924) (same).

[8] This issue is not a necessary predicate to resolution of the question presented because the operational function test is resolved separately from the unitary business test. *Allied-Signal*, 504 U.S. at 787. Illinois, however, asks this Court to address the issue, Resp. Br. 34-40, and noticed the issue in their brief in opposition, *see* Br. in Opp. 7, 9 n.3 (discussing test and relying on its cases), and before the Illinois trial and appellate courts, so the record allows review of the issue.

reasonably possible, defer to the judgment of state courts in deciding whether a particular set of activities constitutes a 'unitary business.'" *Container Corp.*, 463 U.S. at 175. Thus, if the state trial court applied the correct legal standard, the Court will grant deference to its conclusion if that conclusion "was within the realm of permissible judgment." *Id.* at 176 (quoting *Norton Co.*, 340 U.S. at 538).

The trial court here applied the correct legal standard to determine whether a unitary business relationship existed between Mead and Lexis/Nexis. Pet. App. 39a. The court examined whether Mead and Lexis/Nexis were "functionally integrated," shared "centralization of management," or evidenced "significant economies of scale between the two businesses." This substantive standard is identical to the one repeatedly applied by this Court. *Allied-Signal*, 504 U.S. at 789 (noting that the "hallmarks" of the unitary business test are "functional integration, centralization of management, and economies of scale"); *Container Corp.*, 463 U.S. at 179; *ASARCO*, 458 U.S. at 317; *Mobil Oil*, 445 U.S. at 438.

The trial court found that none of these three critical indicia of a unitary business existed in the instant case. Pet. App. 39a. That determination fell well "within the realm of permissible judgment"; indeed, the ruling is overwhelmingly supported by the record.

The trial court's ruling that Mead and Lexis/Nexis "were not functionally integrated" was

demonstrated by the fact that the two lines of business maintained separate departments and facilities. Pet. App. 35a. This was supported by the facts to which respondents stipulated that established that Mead and Lexis/Nexis maintained separate legal departments, financial staff, accounting departments, audit departments, credit and collection departments, human resources departments, marketing departments, computer systems, bank accounts, and personnel. J.A. 10-13. In light of this overwhelming evidence, the trial court concluded that Mead's "involvement for extraordinary purchases requiring capital investment and the interest rate advantage gained by Mead through the nightly sweep of bank accounts is not sufficient evidence that the two were functionally integrated." Pet. App. 35a.

Similarly, based upon those stipulated facts, the state trial court determined that "Mead and Lexis/Nexis did not share a centralized management." Pet. App. 36a. The trial court ruled that that evidence was not rebutted by Mead's approval of certain "extraordinary purchases" and Mead's consideration of Lexis/Nexis in its "strategic planning." *Ibid.*

Finally, the trial court held that "[t]here were no economies of scale realized by Mead and Lexis/Nexis" because the two businesses "had separate purchasing departments and no joint purchasing activities." *Ibid.* Neither business even offered the other any discount on the products or services of the other. *Ibid.* In fact, "Lexis/Nexis often bought paper from other vendors." *Ibid.* As such, the only plausible economy of scale the

two businesses realized was the "increased interest rate" due to nightly cash sweeps, *ibid.*, which paled in comparison to the stipulated facts demonstrating the lack of a unitary relationship. Pet. App. 35a-36a; J.A. 10-13.

Respondents now attempt to overturn these rulings by ignoring the stipulated facts to which they agreed in the trial court, but those facts are dispositive of the unitary business test. They unequivocally establish that "Mead was, and is, in the business of producing and selling forest products" and that "Lexis/Nexis provided online information services for legal, news and financial information in the electronic publishing market." J.A. 9-10. Although Mead owned Lexis/Nexis, "Lexis/Nexis had its own full-time management to control its day-to-day operations." J.A. 13. The two divergent businesses had separate departments for every function, and the two businesses did not share personnel or any financial staff. J.A. 10, 13. The two businesses maintained separate and distinct training programs, computer systems and bank accounts. J.A. 11-12.

B. Respondents Misconstrue The *Container Corporation* Ruling

1. Respondents invoke *Container Corporation* in an attempt to turn the Mead paper and office supply business and the Lexis/Nexis online information service into one unitary business. Resp. Br. 34.

Respondents' reliance on *Container Corporation* is misplaced because this Court in *Allied-Signal* explained that in *Container Corporation*, the hallmarks of the unitary business relationship remained functional integration, centralization of management, and economies of scale. *Allied-Signal*, 504 U.S. at 789. *Container Corporation* demonstrated that these essentials could be shown through "transactions not undertaken at arm's length; a management role by the parent that is grounded in its own operational expertise and operational strategy; and the fact that the corporations are engaged in the same line of business." *Ibid.* (citing *Container Corp.*, 463 U.S. at 178, 180 n.19). None of those factors are present in the instant case. *See* J.A. 10-13.

Indeed, respondents begrudgingly recognize one of these significant distinctions between the instant case and *Container Corporation*, *i.e.*, "the taxpayer in [*Container Corporation*] was engaged in the same basic line of business as its subsidiaries." Resp. Br. 37. Although respondents try to discount that distinction as "immaterial," *ibid.*, that fact was critical to the Court's holding. The Court indicated that it was reasonable to presume that two related corporations engaged in the same line of business are unitary. The Court explained that, where "a corporation invests in a subsidiary that engages in the same line of work as itself," "it becomes much more likely that one function of the investment is to make better use—either through economies of scale or through operational integration or sharing of

expertise—of the parent's existing business-related resources." *Ibid.* The Court contrasted that with the situation where, as here, there is an "[i]nvestment in a business enterprise truly 'distinct' from a corporation's main line of business," which "often serves the primary function of diversifying the corporate portfolio and reducing the risks inherent in being tied to one industry's business cycle." *Container Corp.*, 463 U.S. at 178.

Container Corporation demonstrates the practical implications of this reasoning because the technical assistance and equipment that the parent in that case shared with its subsidiary were unquestionably of significant value due to the fact that the parent and its subsidiary were in the same line of business. *Id.* at 172 (noting that "groups of foreign employees occasionally visited the United States for 2-6 week periods to familiarize themselves with [the taxpayer's] methods of operation" and that five executives of the taxpayer were charged "with the task of overseeing the operations of the subsidiaries");[9] *id.* at 173

[9] Exchanges of personnel, training programs, or day-to-day executive oversight did not occur between Mead and Lexis/Nexis. J.A. 10-13. Respondents identify three executives who worked for both businesses at some point. Resp. Br. 7. In fact, the record indicates that only a half dozen of 4000 Lexis/Nexis employees ever worked at Mead. J.A. 173. There is no evidence that even these were *strategic* transfers of personnel by Mead. Rather, the evidence supports the opposite conclusion because one of the three executives testified that he moved to Mead simply because he wanted to leave Lexis/Nexis for "personal" reasons. *Ibid.*

(explaining that parent could "provide[ ] advice and consultation regarding manufacturing techniques, engineering, design, architecture, insurance, and cost accounting" to its subsidiaries); *id.* at 179 (relying on the "'substantial' technical assistance provided by [the parent] to the subsidiaries"); *see also Exxon Corp.*, 447 U.S. 207 (subsidiaries in the same line of business as parent); *Mobil Oil*, 445 U.S. 425 (same).

2. Mead's infrequent approval of major capital expenditures by Lexis/Nexis, J.A. 15-16, bears no similarity to the manner in which the taxpayer in *Container Corporation* assisted its subsidiaries. Resp. Br. 35. Unlike the acquisition of computer equipment in the instant case, the assistance provided by the parent in *Container Corporation* was extensive because the parent "assisted its subsidiaries in their procurement of equipment, either by selling them used equipment of its own or by employing its own purchasing department to act as an agent for the subsidiaries." *Container Corp.*, 463 U.S. at 173. Thus, in contrast to *Container Corporation*, Mead's conduct here was the "type of occasional oversight—with respect to capital structure, major debt, and dividends—that any parent gives to an investment in a subsidiary," without creating a unitary business. *Woolworth*, 458 U.S. at 369.[10]

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[10] Respondents argue that Mead was run "in a decentralized fashion" (Resp. Br. 6), implying that Mead's hands-off approach toward Lexis/Nexis supports a unitary business relationship between the two. The record demonstrates, however, that

(Continued on following page)

Tellingly, respondents repeatedly assert that there was control of Lexis/Nexis by Mead, but they do not have accurate record support. Respondents argue that Mead "reviewed" the business plan of Lexis/Nexis, Resp. Br. 27, but the testimony they cite demonstrates only that once a year Lexis/Nexis would "explain [its] business plan and that was pretty much it." J.A. 163. Moreover, respondents contend that "Mead, not Lexis/Nexis, decided how to invest Lexis/Nexis's excess cash." Resp. Br. 27. The trial testimony cited by respondents, however, demonstrates that Lexis/Nexis "could have set up the banking relationships * * * but *chose* not to." J.A. 181 (emphasis added).[11]

Respondents' claim that Mead and Lexis/Nexis must be considered a unitary business because Mead submitted a consolidated tax return to Illinois is meritless. Resp. Br. 4-5, 9, 38. As Illinois conceded by stipulation, and the trial court recognized, the consolidated tax return came about because Illinois required Mead to file such a return and Mead did so only to settle that dispute. J.A. 13; Pet. App. 39a

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Lexis/Nexis "was much more independent than other divisions of * * * Mead." Ill. C.A. Rec. Vol. 9 at 112. Unlike Lexis/Nexis, which "always had their own," Mead's other divisions "shared services, procurement, HR, computer systems, things of that nature." *Ibid.*

[11] Respondents also cite to Mead's approval of compensation and bonuses for certain Lexis/Nexis executives. Resp. Br. 27 (citing J.A. 146). But the record demonstrates that Mead did so for only a handful of the thousands of Lexis/Nexis employees. J.A. 13.

(noting the filing was "at the direction of" respondents and not probative).[12] Respondents' current position would require all nonunitary divisions of a multistate corporation that are included in a consolidated return to be *per se* taxable as part of the taxpayer's unitary business, in conflict with the decisions of this Court. *Mobil Oil*, 445 U.S. at 440.[13]

III. RESPONDENTS WAIVED THEIR MERITLESS ARGUMENT THAT THE RELATIONSHIP BETWEEN LEXIS/NEXIS AND ILLINOIS ALLOWS RESPONDENTS TO TAX MEAD'S CAPITAL GAIN

Respondents contend that the Constitution permits a State to tax an out-of-state investor's capital gain based solely on ties between the *investment* and the taxing State. Resp. Br. 18-31, 46-49; *see also* Br. of Multistate Tax Commission as *Amicus Curiae* Supporting Respondents 17-19 (MTC Br.). Under this argument, a State could impose a capital-gains tax on an investor even if the investment is not part of the

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[12] Because States employ different standards as to when a corporation and its subsidiaries must file a consolidated versus a separate return, what state law requires cannot dictate what the Constitution permits or else the limits of the Due Process and Commerce Clauses would be meaningless.

[13] Respondents argue that Mead had "leeway as to how it characterizes its business" in its reports and filings. Resp. Br. 30. But such "leeway" would not have permitted Mead to not report ownership of Lexis/Nexis as an electronic publishing business. Moreover, this Court places little significance on such reports. *Woolworth*, 458 U.S. at 369 n.22.

investor's unitary business and did not serve an operational function.

A. Respondents Failed To Preserve This Argument In The State Appellate Court

Respondents repeatedly argue in their brief to this Court that the relationship between Lexis/Nexis and Illinois alone justifies Illinois's tax on Mead's capital gain. Resp. Br. 18-31, 46-49. But respondents did not raise this argument in the state appellate court (and the court did not raise the issue *sua sponte*). Rather, respondents argued that there were "two circumstances" where the Constitution permitted the State to apportion to itself for taxation a part of Mead's capital gain from its Lexis/Nexis sale: (1) if Mead and Lexis/Nexis had a unitary business relationship and (2) if Mead's investment in Lexis/Nexis served an operational function. C.A. Br. of Illinois 24-25.

Respondents thus waived under state law the argument they now press that a connection between the *investment* and the State sustains the Illinois tax. A party that fails to raise an argument in the Illinois appellate court waives that argument by operation of state law. *See* Ill. S. Ct. R. 341(h)(7), (i) (points not argued by the appellee are waived); *Elementary Sch. Dist. 159 v. Schiller*, 849 N.E.2d 349, 358 n.2 (Ill. 2006) (appellee must raise all arguments it wishes to preserve in its brief).

That waiver in state court bars respondents from bringing the issue to this Court, because an alternative ground for affirmance is waived in this Court if it was not raised in, nor passed upon by, the appellate court below. *See, e.g.*, *Glover v. United States*, 531 U.S. 198, 205 (2001) (refusing to consider alternative arguments for affirmance that were not raised in court of appeals); *Heckler v. Campbell*, 461 U.S. 458, 468 n.12 (1983) (same); *McGoldrick v. Compagnie Generale Transatlantique*, 309 U.S. 430, 434 (1940) (same with respect to state courts).[14]

B. This Argument Raises Issues That Could Affect Other States Who Were Not On Notice Of The Argument From The *Certiorari*-Stage Briefing

Respondents' argument based on Lexis/Nexis's connection to the State as a justification for Illinois's taxation of Mead's capital gain also should not be addressed by this Court because it asks this Court to reach out and decide a constitutional question that has limited relevance to the ordinary operation of the Illinois taxation scheme, and one that could directly

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[14] As respondents point out, Resp. Br. 23 n.7, they may urge affirmance on any ground supported by the record. But an argument that was not preserved in the appellate court is waived. *Lorillard Tobacco Co. v. Reilly*, 533 U.S. 525, 578 (2001) (Thomas, J., concurring in part and concurring in the judgment) (The Court does "not consider arguments for affirmance that were not presented below.").

affect other statutory schemes that are not before this Court. *Illinois v. Gates*, 462 U.S. 213, 221, 224 (1983); *Roberts v. Galen of Virginia, Inc.*, 525 U.S. 249 (1999) (per curiam).

With respect to the taxation of capital gains from intangible investments (such as from the sale of Lexis/Nexis), Illinois's taxation scheme does not turn on whether the investment has ties to Illinois. Rather, under Illinois law, apportionability of such a gain depends upon the relationship between the investment and the taxpayer. *See* 35 Ill. Comp. Stat. Ann. 5/303(a), (b)(3), 5/304(a) (West 1994); Pet. App. 15a. In the absence of a sufficient connection between the investment and the taxpayer *under state law*, Illinois does not tax the capital gain, regardless of whether or not ties exist between the investment and the State. Jerome R. Hellerstein & Walter Hellerstein, *State Taxation* § 9.11[2][a] (3d ed. 2007).

By contrast, States such as New York calculate their tax based on the relationship between the investment and the State. *See, e.g.*, N.Y. Tax Law § 210(3)(b) (Consol. 2007); *In re Allied-Signal, Inc.* (*Allied-Signal II*), 645 N.Y.S.2d 895, 898 (N.Y. App. Div.), *appeal dismissed*, 675 N.E.2d 1234 (N.Y. 1996); Hellerstein, *supra*, at § 9.11[2][a]. Such States have a much greater interest in this waived argument, because the constitutional permissibility of such taxation schemes rises and falls upon respondents' argument.

The States that could be greatly affected by resolution of this argument were not on notice to participate as *amicus* on this issue and, for example, New York did not do so.[15] Respondents did not raise this argument in their brief in opposition, which alone should preclude this Court's consideration, S. Ct. R. 15.2.[16]

C. Reliance On An Investment's Relationship With The Taxing State To Tax An Investor Cannot Be Squared With This Court's Precedents

Respondents' argument that Illinois may tax Mead for its capital gain based solely on a connection between Lexis/Nexis and Illinois is without merit.

Respondents cannot prevail on this argument based merely on their repeated citation (and that of their *amici*) to general principles of constitutional law with which petitioner has no disagreement—that a State can tax a taxpayer with which it has minimal

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[15] After this Court decided *Allied-Signal*, the constitutionality of New York's scheme of taxing investors based on the relationship between the investment and the State was challenged. *See Allied-Signal II*, 645 N.Y.S.2d at 898-899. An intermediate state appellate court rejected that challenge, *ibid.*, and the New York Court of Appeals declined review, 675 N.E.2d 1234. No *certiorari* petition was filed.

[16] Indeed, respondents even rephrased the question presented in their brief in opposition, but neglected to raise the argument that they now press and which they had waived in the state appellate court.

connections and to which it provides opportunities, protections, and benefits, Resp. Br. 18, 23, and that "an out-of-state company is subject to tax in any State in which it conducts business," *id.* at 46. In fact, such taxes were paid here on an apportioned share of Lexis/Nexis's income earned in Illinois, as well as on an apportioned share of Mead's income earned in Illinois. Respondents, however, would expand the State's taxing authority far beyond that.[17]

1. Respondents' position is foreclosed by *Allied-Signal*, where this Court addressed circumstances virtually identical to the instant case—*i.e.*, a State's taxation of a nondomiciliary company's capital gain resulting from the sale of an investment that also did business in the taxing State. Specifically, in *Allied-Signal* a nondomiciliary taxpayer challenged New Jersey's tax on its capital gain arising from the sale of an investment (stock). 504 U.S. at 773-774. Just as in the instant case, the investment did business in New Jersey (and, in fact, was a New Jersey corporation). *Ibid.*

The connection between the investment and the taxing State did not preclude this Court from invalidating the tax on the nondomiciliary investor

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[17] The suggestion of *amicus* MTC that the goodwill taxed here had a taxable business situs in Illinois (MTC Br. 21-23) is wrong. The cases cited by MTC involve intangible property of the taxpayer's unitary business. *Adams Express*, 165 U.S. at 219. Passive investments are not subject to the business situs principle. *Id.* at 222.

as unconstitutional under both the unitary business and operational function tests. As the *amici* States concede (Br. of California et al. as *Amici Curiae* Supporting Respondents 12), the relevant constitutional inquiry under *Allied-Signal* "focuses on the objective characteristics of the asset's use and its relation to the taxpayer and [the taxpayer's] activities within the taxing State," 504 U.S. at 785, not on the relationship between the asset and the taxing State.

2. The authorities that respondents cite do not hold otherwise. Respondents rely heavily on *International Harvester Co. v. Wisconsin Department of Taxation*, 322 U.S. 435 (1944), and *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940), as purportedly justifying their argument that Lexis/Nexis's connection to Illinois is enough to tax Mead for the capital gain on its sale of Lexis/Nexis. But neither of those cases supports respondents. Those cases stand for the unremarkable proposition that a State has the power to tax a business for its share of income that the business earned within its borders.

Both cases arose because of a Wisconsin law that required corporations doing business in that State to pay a tax on dividends distributed to shareholders. *Int'l Harvester*, 322 U.S. at 437; *J.C. Penney*, 311 U.S. at 439-440. This Court upheld in both instances a Wisconsin tax on an apportioned share of the dividend, because the business was being conducted in the taxing State. *Int'l Harvester*, 322 U.S. at 438, 442; *J.C. Penney*, 311 U.S. at 440 n.1, 444-445. The Court reached this result because the tax in these

cases was a deferred income tax imposed on the corporation that did business within the State, and not on an out-of-state investor shareholder that received dividends. *Int'l Harvester*, 322 U.S. at 441 ("The power to tax the corporation's earnings includes the power to postpone the tax until distribution of those earnings * * * ."); *id.* at 447 (Jackson, J. dissenting) (explaining that the majority can sustain the tax because it is "an income tax on the corporation, deferred until the income was distributed," even though the dissent views that it "is not an income tax * * * but is a tax on the stockholder"); *J.C. Penney*, 311 U.S. at 442 ("The practical operation of this legislation is to impose an additional tax on corporate earning within Wisconsin but to postpone the liability for this tax until earnings are paid out in dividends."). In the instant case, by contrast, Illinois is taxing the out-of-state investor, Mead, rather than its investment, Lexis/Nexis.

These precedents are consistent with this Court's unitary business and operational function precedents. In *Allied-Signal* and its predecessor decisions, just like *International Harvester* and *J.C. Penney*, this Court permitted a State to tax a company on the apportioned share of the income (or dividends) that are directly attributable to the company's unitary business in the State. But this Court's precedents do not support the proposition that a State can tax a company on an apportioned share of a capital gain that is unrelated to the company's unitary business conducted in that State, merely because the

investment associated with the gain has a connection to the taxing State.

Indeed, under respondents' theory, every out-of-state investor could have to pay taxes on the capital gain from a passive investment in every State where the investment does business. The Constitution certainly does not permit such a result.

IV. A Ruling In Respondents' Favor Would Upset Settled Expectations And Create A Risk Of Duplicative Taxation

A. Respondents propose an unconstrained rule so that a State may apportion "any gain realized from the sale of a subsidiary[ ] over which the taxpayer had considerable control and with which it dealt regularly." Resp. Br. 57. This rule would transform every wholly-owned subsidiary into an operational asset of the parent, and create chaos because States and corporations have relied upon this Court's well-settled principles to the contrary.

As this Court has recognized, state legislatures have relied on this Court's distinction between assets that serve an operational function and those that serve an investment function—the very distinction that Illinois seeks to eviscerate. *Allied-Signal*, 504 U.S. at 785 ("State legislatures have relied upon our precedents by enacting tax codes which allocate intangible nonbusiness income to the domiciliary State * * * ."). Multistate corporations likewise have relied on *Allied-Signal* in structuring transactions

with a degree of tax certainty. *See* Br. of The Walt Disney Company, as *Amicus Curiae* Supporting Petitioner 25-26.

The reliance placed upon this Court's precedent is demonstrated by the consistently narrow interpretation of the operational function test by state courts in the fifteen years since *Allied-Signal*. *OSG Bulk Ships*, 961 P.2d at 414. Other than the decision below, state courts have repeatedly held that an investment does not serve an operational function where it was used neither as a source of working capital nor as a hedge against a fluctuating supply of a key commodity. *See Hercules Inc. v. Commissioner of Revenue*, 575 N.W.2d 111, 117 (Minn. 1998); *Hercules Inc. v. Comptroller of Treasury*, 716 A.2d 276, 281-284 (Md. 1998) (observing that this Court "has not encompassed strategic, long-range decisions of a company within operational functions").[18] The drastic modification of the operational function test suggested by respondents "would disrupt * * * an area of the law in which the demands of the national

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[18] Respondents inexplicably suggest that the *Hercules* courts' determination of no-operational function was based on the fact that the taxpayer exercised no control over the asset. Resp. Br. 56-57. The issue of control was one factor (of many) in these courts' unitary-relationship analyses, 575 N.W.2d at 116; 716 A.2d at 280-281, but there was no discussion of exercise of control in the courts' application of the operational function test, 575 N.W.2d at 116-117; 716 A.2d at 281-284. Illinois's reliance (Resp. Br. 55) on the California Supreme Court *Hoechst Celanese* decision is also misplaced, as noted above, *see* page 11.

economy require stability." *Allied-Signal*, 504 U.S. at 786.

B. This case is not just about Illinois's attempt to tax an apportionment of Mead's capital gain. Resp. Br. 50. Under respondents' rule, every State where a corporation does business could tax an apportionment of the capital gain earned by that corporation from intangibles. Such taxing authority by nondomiciliary States would be in addition to the constitutional authority of the domiciliary State to tax the entirety of such a gain. *Mobil Oil*, 445 U.S. at 444 ("Taxation by apportionment and taxation by allocation to a single situs are theoretically incommensurate * * * .").

Such potential for double taxation is the final defeat for respondents. Contrary to their claim (Resp. Br. 50-51), this Court has never required evidence of duplicative taxation in a particular case to invalidate an unconstitutional taxing scheme that would allow such duplication. Indeed, the potential for double taxation was an express concern of the Court in *Allied-Signal*. *See* 504 U.S. at 785 ("Were we to adopt New Jersey's theory, we would be required" to "authorize what would be certain double taxation.").[19]

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[19] Respondents are wrong that *Kemppel v. Zaino*, 746 N.E.2d 1073 (Ohio 2001) dictates that Ohio would have apportioned the capital gain. That case concludes that, under Ohio law, capital gains from a business's total liquidation are allocated to the taxpayer's domicile. *Id.* at 1076-1077.

CONCLUSION

For the reasons set forth above and in petitioner's opening brief, the Court should reverse the judgment below.

Respectfully submitted,

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In The Supreme Court of the United States

MEADWESTVACO CORPORATION, successor in interest to THE MEAD CORPORATION,

Petitioner,

v.

ILLINOIS DEPARTMENT OF REVENUE, DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE, AND TREASURER OF THE STATE OF ILLINOIS,

Respondents.

On Writ Of Certiorari To The Appellate Court Of Illinois

BRIEF OF THE STATES OF CALIFORNIA, ARKANSAS, CONNECTICUT, FLORIDA, IDAHO, INDIANA, IOWA, KANSAS, MAINE, MARYLAND, MICHIGAN, MINNESOTA, MISSOURI, NEVADA, NEW HAMPSHIRE, NORTH DAKOTA, OKLAHOMA, OREGON, PENNSYLVANIA, SOUTH CAROLINA, TENNESSEE, UTAH, VERMONT, AND WEST VIRGINIA, AND THE COMMONWEALTH OF PUERTO RICO AS AMICI CURIAE IN SUPPORT OF RESPONDENTS

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QUESTION PRESENTED

Whether the Court should adopt a set of rigid standards to replace the flexible test described in *Allied Signal v. Director*, 504 U.S. 768 (1992) for determining whether States may apportion corporate income under the Due Process and Commerce Clauses?

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INTEREST OF AMICI CURIAE

Every State has an interest in how the Supreme Court resolves the issues presented in the instant case. As the California Supreme Court put it not long ago, "[s]tates have long struggled to devise an equitable and constitutional method for taxing corporations that do business in multiple states and countries." *Hoechst Celanese Corporation v. Franchise Tax Board*, 22 P.3d 324, 328 (Cal. 2001). In the process, all States have attempted to fashion ways to determine the amount of a multistate enterprise's income that may properly be taxed by the State, while at the same time acknowledging that there are limits that must be recognized. For the last 15 years States have been guided in this effort by this Court's decision in *Allied Signal v. Director*, 504 U.S. 768 (1992) and have developed a settled body of law based on that case.

Amici share with Illinois a common respect for the limits upon state income taxation which arise from the Due Process and Commerce Clauses of the Constitution. Amici urge this Court to reaffirm its previous articulation of the constitutional standard for such taxation, and not to adopt the narrower constraints on state apportionment of the multistate income of a multistate business proposed by petitioner.

SUMMARY OF ARGUMENT

The amici States ask the Court to continue the traditional, flexible approach to apportionment that this Court most recently affirmed in *Allied Signal v. Director, Division of Taxation*, 504 U.S. 768 (1992) ("*Allied Signal*") and reject Mead's attempt to replace it with two rigidly delineated tests.

States have applied *Allied Signal* for fifteen years without undue difficulty or controversy. Under the Due Process and Commerce Clauses, a State may not tax income that a corporation generated outside its borders. It may, however, tax income when there is a "minimal connection" and a "rational relation" between the State and the income. The touchstone for these constitutional limits is the unitary business principle. Under this principle, the various activities of a business may be viewed as a single enterprise – thus establishing the requisite connection between a State and the business' income-generating components – when value flows between the components. Unlike income, flows of value can be subtle and difficult to quantify. Thus, in the case of a taxpayer that manufacturers a product in one State and sells it in another, there is a relationship between each of the two States and each of the company's two activities that meets the constitutional standard. Likewise, the requisite connection exists when a rail line that passes through one State makes possible the operation of a railroad connecting commercial centers located in other States.

Although Mead concedes "that this Court's test works in practice and that adoption of any new rule will disturb settled expectations upon which States and corporations rely," (Pet. Brief, pp. 48-49), it attempts to redefine the existing, flexible standard as two rigid, mutually exclusive tests, which it calls the unitary business principle and the operational function test. There are several problems with Mead's approach.

First, Mead is confusing three distinct concepts. There is just one test which determines whether there is a flow of value between the relevant income-generating components of a corporation: whether there exist the required minimal connection and rational relation. Mead confuses this test with two scenarios in which the test has been applied. One scenario describes a *unitary business relationship*, in which various income-generating business are sufficiently connected through transfers or flows of value to be viewed as a single enterprise for tax apportionment purposes. A second scenario describes an *operational function*, in which an asset supports the corporation's multistate operations. These two concepts are not themselves constitutional tests; rather, they are applications of the unitary business principle to different factual circumstances. In each instance, the constitutional standard is met because value flows between a corporation's various businesses (unitary relationship) or between an asset and the taxpayer's multistate business activities (operational

function), and thus the minimal connections and rational relations exist.

In addition to misconstruing the unitary business principle, Mead attempts to narrow the standard in various ways. It suggests that operational functions and unitary relationships are mutually exclusive concepts. In fact, in the diverse world of business, the factors that indicate one or the other may well overlap. Indeed, this Court has resisted a rigid approach to the issue because "any number of variations on the unitary business theme 'are logically consistent with the underlying principles motivating the approach.'" *Allied Signal*, 504 U.S. at 785, quoting *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 167 (1983) ("*Container*"). Likewise, using the facts of this single case, Mead effectively would have the Court deem irrelevant entire categories of evidence in future cases. The Court has prudently resisted prescribing rigid formulae for lower courts to use when applying the unitary business principle, noting that "the constitutional test is quite fact sensitive," *id.*, and it should continue to do so.

Amici States are also concerned that Mead is attempting to undermine the burden of proof. By arguing that the State has failed to satisfy the constitutional minimum, Mead obliquely suggests that the State bears the burden on the issue. It is well-settled, however, that the taxpayer "has the burden of proof; it must demonstrate that there is 'no rational relationship between the income attributed to the State and the intrastate values of the enterprise.'"

Container, 463 U.S. at 180. Clarity on this issue is crucial for the States. The taxpayers, after all, control the records, data, and other information that reveal the nature of their often-complex businesses.

Here, Mead has failed to meet its burden. Under the unitary business principle, the ultimate question is whether Mead has demonstrated that there was no flow of value between Lexis and Mead's multistate business. Mead manipulated its corporate structure when it merged Lexis into Mead for the purpose of setting off against the gains of one part of the business the losses incurred by another part, with the result that Mead expected an ongoing savings in its state income tax burden caused by the reduction in the amount of its apportionable income that would have been taxed. The decrease in that tax burden would have caused an increase in Mead's net after-tax apportionable income. Consequently, there is evidence of a flow of value between Lexis and Mead's multistate business sufficient to establish the minimal connections and rational relation required by the Constitution.

ARGUMENT

I. State Apportionment Of Income Is Proper If There Are Sufficient Connections Between The Income To Be Taxed And The State Imposing The Tax

In its decision in *Allied Signal*, based on its review of earlier precedent, this Court noted that a State's imposition of tax on an apportioned share of a multistate business' income is subject to the Due Process and Commerce Clauses of the Constitution. These clauses require that there be "some definite link, some minimum connection, between a State and the person, property or transaction it seeks to tax." *Allied Signal*, 504 U.S. at 777. A single State may tax the multistate income of a nondomiciliary corporation if there is a "minimal connection" between the interstate activities and the taxing State, and if there is "a rational relation between the income attributed to the taxing State and the intrastate value of the corporate business." *Id.* at 772.

This Court's precedents make it clear that the determination concerning the existence of sufficient connections and rational relations does not involve the application of formalized rules. As this Court put it in *Allied Signal*, "modern due process jurisprudence rejects a rigid, formalistic definition of minimum connection." *Id.* at 778.

The sufficient connections and rational relations are satisfied by the unitary business principle. It is a

principle which takes into account the transfers of value which can occur among the components of an interstate business enterprise when they function together. *Id.* at 783.

The unitary business principle has its roots in Nineteenth Century cases involving the application of property taxes to property owned by railroads and telegraph companies:

> When States attempted to value railroad or telegraph companies for property tax purposes, they encountered the difficulty that what makes such a business valuable is the enterprise as a whole, rather than the track or wires that happen to be located within a State's borders. The Court held that, consistent with the Due Process Clause, a State could base its tax assessments upon 'the proportionate part of the value resulting from the combination of the means by which the business was carried on, a value existing to an appreciable extent throughout the entire domain of operation.'

Allied Signal, 504 U.S. at 778-779, quoting from an 1897 opinion. Thus, the various physical components were considered in the aggregate in assessing their value. The rail passing over the distant prairies and through the uninhabited deserts had a value which took into account the fact that it linked the great commercial centers of the East and Midwest with the growing population centers of the West Coast. Later, this concept of physical unity was applied to other

sorts of unity, and eventually the unitary business principle was applied to the taxation of corporate income. *Id.*

Given its history, it is not surprising that this Court recognizes the principle's flexibility. "[T]he unitary business principle is not so inflexible that as new methods of finance and new forms of business evolve it cannot be modified or supplemented where appropriate." *Id.* at 786. The unitary business principle is "workable in practice" because it is not rigid or formalistic. *Id.* at 785.

> If lower courts have reached divergent results in applying the unitary business principle to different factual circumstances, that is because, as we have said, any number of variations on the unitary business theme 'are logically consistent with the underlying principles motivating the approach.'

Id. at 785, quoting from *Container*. Likewise, this Court has recognized that the constitutional test is very "fact sensitive." *Id.*

II. The Existence Of Either A Unitary Relationship Or An Operational Function Or Purpose Supports A Determination Of Apportionability Under The Unitary Business Principle

A. For Purposes Of Apportionment Of Income, The Unitary Business Principle Views As A Single Enterprise Those Components Of A Multistate Business That Are Minimally Connected And That Are Rationally Related To The Taxpayer's Activities In The Taxing State

Under the unitary business principle, the various components of a business enterprise can be viewed as a single enterprise when value flows or is transferred between the components. *Allied Signal*, 504 U.S. at 783; *Container*, 463 U.S. at 164-165. That is, the principle considers these components to constitute a "unitary business." On that basis, the Constitution allows the income of the unitary business to be apportioned.

> The 'linchpin of apportionability' for state income taxation of an interstate enterprise is the 'unitary business principle.' [Citations deleted.] If a company is a unitary business, then a State may apply an apportionment formula to the taxpayer's total income in order to obtain a 'rough approximation' of the corporate income that is 'reasonably related to the activities conducted within the taxing State.'

Exxon Corp. v. Department of Revenue of Wisconsin, 447 U.S. 207, 223 (1980). The principle applies whether the business enterprise is a single corporate entity or whether it involves several commonly owned corporations. *Container*, 463 U.S. at 164-165; *Barclays Bank PLC v. Franchise Tax Bd.*, 512 U.S. 298 (1994).

A transfer or flow of value is not the same thing as income. Income is quantifiable. However, as this Court has noted, a flow or transfer of value among components of a business can be "subtle and largely unquantifiable." *Container*, 463 U.S. at 164-165. The rail linking the various commercial centers served by a railroad contributes value because it makes possible the generation of income. This is true even though the rail itself is not a source of income and does not produce quantifiable income. In the case of a multi-jurisdictional business which manufacturers its product in one state and sells it in another, the income may arise in just the second state, but the manufacturing in the first state obviously contributed to the value of the company's interstate business. *See, e.g.*, discussion in *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 438-439 (1980).

B. The Existence Of A "Unitary Relationship" Among Subsidiaries Or Divisions Satisfies The Constitutional Standard For Apportionment

The phrase "unitary relationship" typically is used to refer to the relationship between a taxpayer

and its subsidiaries, or between a taxpayer and its divisions. Most of this Court's recent decisions concerning apportionment of business income have involved such relationships. *See, e.g., Exxon Corp., supra*; *F.W. Woolworth Co. v. Taxation & Revenue Department of the State of New Mexico*, 458 U.S. 354 (1982) ("*Woolworth*"); *Mobil Oil, supra*, and *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982) ("*ASARCO*"). To conclude that such a relationship exists is to conclude that there exist the minimal connections and rational relationship required by the Constitution. In any event, Mead does not dispute that a "unitary relationship" is a basis for apportioning income.

C. The Constitutional Standard Is Also Satisfied When An Asset Serves An Operational Function Or Purpose For The Taxpayer's Multistate Business

This Court also recognizes the fact that the unitary business principle applies, and justifies apportionment of income, when there exists an operational function between the taxpayer's business and the asset in question. This concept, like the unitary business principle itself, can be traced back to the railroad and telegraph cases mentioned above. The rail that links two commercial centers makes possible the commercial exchanges that occur between them and thus adds value to the railroad which owns and operates its trains over that rail. That rail itself

constitutes an asset that serves an operational purpose or function.

Thus, the unitary business principle does not apply only to unitary relationships. As this Court stated in *Allied Signal*, commenting on earlier cases, "[w]e did not purport, however, to establish a general requirement that there be a unitary relation between the payor and the payee to justify apportionment, nor do we do so today." *Allied Signal*, 504 U.S. at 787. In the same portion of its opinion, this Court also noted that "[t]he existence of a unitary relation between payee and payor is one justification for apportionment, but not the only one." *Id.* Another justification is that the asset "serve an operational rather than an investment function." *Ibid.*, citing *Container*, 463 U.S. at 180, n. 19.

In determining whether an asset serves an operational function, the relevant inquiry should focus "on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State." *Allied Signal*, 504 U.S. at 785. This is the inquiry that must be pursued in order to determine if the constitutionally required minimal connections and rational relationship exist.

D. By Contrast, An Asset Of Any Kind Which Is Not Linked To The Taxpayer's Multistate Business Serves Only An Investment Function, And Income Derived From It Is Not Apportionable

Not all assets owned by a taxpayer engaged in a multistate business exhibit the minimal connections and rational relationship that would satisfy the constitutional standard. Those assets which do not satisfy the standard serve an investment function or purpose.

Assets that serve only an investment function can include not only physical assets, such as real property, or intangible assets such as stock, but also divisions and subsidiaries. Such assets may contribute income to the taxpayer. However, as this Court indicated in *Allied Signal*, the mere fact that an asset generates income for the taxpayer is not enough. *Allied Signal*, 504 U.S. at 784-785. If an asset does not contribute to the generation of *apportionable* income, the constitutional standard is not satisfied. There is no minimal connection or rational connection, there is no flow of value between the asset and the multistate business, and hence there is neither a unitary relationship nor an operational function. Such an asset serves only an investment function. Any income derived from such an asset is allocated to one State (usually either the taxpayer's domicile or the situs of the asset as in the case of real property). Such income therefore is *not* apportioned.

In other words, the fact that an asset is somehow linked to the taxpayer, as through ownership, is not sufficient. The asset must be linked to the taxpayer's multistate business (*i.e.*, to that business activity which generates apportionable income) *in such a way* that the minimal connections and rational relationship exist.

III. Mead's Argument Fundamentally Misconceives The Operational Function Concept And Would Limit Its Utility

Although Mead appears to accept the concept of an operational function, its argument represents an effort to so limit its application as to eviscerate it. However, Mead's arguments are fundamentally flawed.

Mead's arguments are based on numerous misconceptions. Mead confuses the "unitary business principle" with the "unitary relationship," mistakenly characterizes what it calls the operational function test as a "narrow exception," and contends that evidence which is relevant to whether a unitary relationship exists cannot be relied upon in determining whether an asset serves an operational function. Mead also proposes a rule that would serve to prevent a trial court from considering what might very well be relevant evidence for purposes of determining apportionability. Through these means, Mead seeks

to isolate the concept of the operational function and to limit its application.

A. The "Unitary Business Principle" Is Not The Same Thing As A "Unitary Relationship"

Mead evidences confusion regarding the terms "unitary business principle," "operational function," and "unitary relationship." In numerous portions of its analysis, it refers to the "unitary business principle" and the "operational function test" as two parallel but discrete concepts. For example, at page 26 of its brief, Mead states, "The unitary business principle and the operational function test seek to capture the 'subtle and largely unquantifiable' in-State contributions to the overall value of a multi-state business." (Pet. Brief, p. 26; *see also*, pp. 27 and 44.)

By pairing "unitary business principle" with "operational function," Mead is treating the former as a synonym for "unitary relationship," and the latter as a concept separate and apart from "unitary business principle." This fact is confirmed by the following statement:

> Apportionment is permissible under the *unitary business principle* only where several businesses, as part of common ownership or as different parts of the same business, are so functionally dependent upon each other that the value of the whole is greater then [sic] the sum of its parts.

(Pet. Brief, p. 26; emphasis added.) In fact, what Mead is describing in the above quoted passage is a *unitary relationship.*[1]

Mead's confusion of these terms is not a mere curiosity. It affects and misdirects its analysis in general, as is demonstrated below.

B. An Operational Function Is Not A "Narrow Exception" To The Unitary Business Principle

Mead's misuse and confusion of the terminology has consequences for its analysis. It is part of the foundation for its erroneous assertion that operational function (or what it calls the operational function "test") is a "narrow exception" to the unitary business principle.

Mead appears to recognize that there are two avenues to determining whether income can be apportioned; one that is based on the existence of an operational function, and the other which it mistakenly

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[1] Mead's reference to the value of the whole being "greater then [sic] the sum of its parts" is not supported by any cited authority. Although in many instances the aggregate value of a business enterprise may be enhanced by the unification of various elements, all that is required is a flow of value, not an enhancement of the type Mead suggests. Adoption of a rule that requires that the whole of a business enterprise exceed the value of the sum of its individual parts in order to establish a unitary relationship, or otherwise satisfy the unitary business principle, would cause enormous mischief.

refers to as the unitary business principle when it should be referring to the existence of a unitary relationship. It compounds that error by confusing what is meant by this Court when it refers to "the linchpin of apportionability."

This analytical flaw is vividly demonstrated in the following passage from Mead's brief:

> [T]his Court has repeatedly held that "the *linchpin* of apportionability in the field of state income taxation is the unitary-business principle." *Mobil Oil*, 445 U.S. at 439 (emphasis added). The operational function test, *by contrast*, constitutes a narrow *exception* that permits a State to tax an apportioned share of income or gain from an asset or investment that is not part of the unitary business. . . .

(Pet. Brief, pp. 25-26; second emphasis added.) In other words, Mead confuses "unitary business principle" with "unitary relationship." Having paired "unitary business principle" with "operational function test," Mead then incorrectly assumes that only one member of the pair, what it terms the "unitary business principle" but which is really "unitary relationship," is the "linchpin." Therefore, Mead erroneously concludes that the other member of the pair, the operational function "test," is a "narrow exception" that is not part of the unitary business principle.

In fact, the existence of an operational function is one of at least two ways in which the unitary

business principle can be applied. One other way is the unitary relationship approach. *See, e.g., Allied Signal*, 504 U.S. at 787. Neither is subordinate to the other, and neither is a "narrow exception" to the other. It is the unitary business principle that is the "linchpin," not the notion of a "unitary relationship."

C. The Factors That Support A Determination That A Unitary Relationship Exists May Also Support The Existence Of An Operational Function

Mead contends that only in limited circumstances can the Court find that an operational function exists. (Pet. Brief, p. 27.) Citing *Allied Signal*, Mead lists only two circumstances that would justify application of the operational function "test":

> where the asset is used to regularly fund the working capital of the unitary business that operates within the taxing State, or where the asset, itself, is designed to support the unitary business with the requisite nexus to the taxing State, such as by providing an ongoing stable supply of key resources.

(Pet. Brief, p. 30.) However, this Court prefaced this comment with the words "for example." *Allied Signal*, 504 U.S. at 787.

Mead's proposed bright line restriction on what may be considered in determining if an operational relationship exists should be rejected. It conflicts with this Court's description of the relevant constitutional

test. That test focuses on "the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State." *Id.* at 785. It also conflicts with this Court's observation that the unitary business principle is flexible and can adapt as "new methods of finance and new forms of business" evolve. *Id.* at 786.

Mead contends that factors which might "inform" whether an asset is part of the taxpayer's unitary business, such as "oversight over and capital investment in the asset," and the description of the asset's business in the taxpayer's annual reports and Forms 10-K, "bear no relation to the operational function test." (Pet. Brief, pp. 17-18.) This contention is based in part on the premise that the two concepts, "unitary relationship" and "operational function," are mutually exclusive. That notion may be in harmony with Mead's view that operational function represents a "narrow exception." However, it conflicts with this Court's rejection of "a rigid, formalistic definition of minimum connection." *Allied Signal*, 504 U.S. at 778.

The fatal flaw in Mead's analysis goes back to its confusion between the terms "unitary business principle" and "unitary relationship." This flaw is revealed in the following statement: "[a] 'flow of value' between a taxpayer parent and its subsidiary or division is relevant to whether there is a unitary relationship and *not to whether the asset . . . served an operational function*, . . . " (Pet. Brief, p. 18; emphasis added.) Yet as this Court has pointed out,

> The principal virtue of the *unitary business principle* of taxation is that it does a better job of accounting for "the many subtle and largely unquantifiable *transfers of value* that take place among the components of a single enterprise" than, for example, geographical or transactional accounting.

Allied Signal, 504 U.S. at 783, quoting from *Container*; emphasis added.

The unitary business principle is an overarching principle that is based on transfers or flows of value. Both "operational functions" and "unitary relationships" are rooted in the essence of the constitutional test, that there be a minimal connection and a rational relationship linking the taxpayer's multi-state business to the asset giving rise to the income. *See Allied Signal*, 504 U.S. at 772. Both of them represent situations in which there is a flow of value between the one and the other. Although they represent "different variations on the theme," they are both "logically consistent with the underlying principles motivating the approach." *Container*, 463 U.S. at 167.

Indeed, as suggested by the foregoing language from *Container*, the concepts of "unitary relationships" and "operational function" are not mutually exclusive categories or concepts. Consequently, it would be a mistake to try to draw a bright line distinction between the two concepts and to endow them with "talismanic" properties. Likewise, it would be wrong to attempt to apply each of them without

reference to the underlying principle which supports both of them, and thus "[to] state[ ] a rule without [understanding] the reasons for it." *See Mobil Oil*, 445 U.S. at 445.

D. Mead's Argument That This Court Should Adopt A Standard That Exceeds This Court's Articulation Of The Constitutional Standard For The Apportionment Of Income Should Be Rejected

Mead contends that:

> This Court permits a State to tax an apportioned share of the gain or income from a nonunitary asset or investment under that [operational function] test only in circumstances where that asset provides a continuing, significant contribution to support the unitary business conducted in the State in some substantial, operational capacity.

(Pet. Brief, p. 29.) Elsewhere, Mead posits the requirement that the asset must provide "critical operational support" which must "sustain and support" the taxpayer's business. (Pet. Brief, pp. 3 and 17.) However, this Court's decisions do not support such characterizations. For example, the Constitution does not require that the asset play a "critical" role.

This Court has already explained what is required by the Due Process and Commerce Clauses. If minimum connections and rational relationships exist, the constitutional standard is satisfied. To the

extent Mead is urging this Court to articulate a new standard for the apportionment of income that exceeds the constitutional standard, its position should be rejected.

E. Mead's Suggestion That Certain Factors Can Never Support Apportionment Should Be Rejected; The Relevance Of Particular Kinds Of Evidence Must Be Determined By The Trier Of Fact On A Case-by-Case Basis

Mead further contends that:

> Illinois's narrow focus on factors that demonstrate no more than the existence of a corporate connection between Mead and Lexis/Nexis as a basis for taxing an apportioned share of Mead's gain from the sale of Lexis/Nexis cannot be squared with this Court's precedents.

(Pet. Brief. 46.) By so contending, Mead attempts to convert an evidentiary dispute into the basis for an absolute legal prohibition against the consideration of certain kinds of facts.

To one degree or another most of the factors cited by the Illinois appellate court can be relevant to a determination of apportionability.[2] No factor which is

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[2] It is not clear that the Illinois appellate court considered "100 percent ownership" to be a factor supporting apportionment. That court's reference to such ownership is in a portion of

(Continued on following page)

potentially relevant should be excluded, as a matter of law, from the universe of facts which a trier of fact has available to it. Moreover, the relevance of facts may become more obvious when they are considered in the aggregate. As this Court has put it:

> We need not decide whether any one of these factors would be sufficient as a constitutional matter to prove the existence of a unitary business. *Taken in combination*, at least, they clearly demonstrate that the state court reached a conclusion "within the realm of permissible judgment."

Container, 463 U.S. at 179-180; footnote del.; emphasis added.

Indeed, Mead's contention that statements in its annual report bear no relation to the existence of an operational function (Pet. Brief, pp. 17 and 37) overlooks the fact that such statements have been viewed by this Court as relevant evidence in other cases. In *Mobil Oil*, for example, this Court relied on the content of the taxpayer's corporate reports as evidence of the fact that the taxpayer's subsidiaries and affiliates were part of its integrated enterprise. *Mobil Oil*, 445 U.S. at 435. In *Container*, as well, this Court

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its opinion where it is distinguishing the instant case from a different case. *Mead Corp. v. Department of Revenue*, 371 Ill. App. 3d 108, 118 (2007). In addition, as this Court has made clear, apportionment can be justified even in the case of minority ownership, depending on the circumstances. *Mobil Oil*, 445 U.S. at 430.

relied on the evidentiary support provided by the taxpayer's Annual Report. *Container*, 463 U.S. at 180, n. 19.

The rules of evidence do not change simply because of the nature of the fact that one seeks to prove. Statements in an annual report are statements of the company that prepared it, as are other documents, such as Forms 10-K, which are filed with the Securities and Exchange Commission, and the state tax returns filed by the taxpayer. Whether such statements are relevant in the context of a specific case, and what weight should be given to them, should be left to the sound discretion of the trier of fact.

Likewise, contributing capital support for the purpose of developing an asset may be relevant to the determination of an operational function in the context of other facts that show that an asset was being developed so as to be used to help the taxpayer generate apportionable income. *See, e.g., Container*, 463 U.S. at 180, n. 19. For the same reason, the fact that a parent company approves major capital expenditures, or manipulates the structure of the business enterprise, such as through merging a subsidiary into the parent corporation, could be relevant.

Indeed, the fact that Mead merged Lexis into the parent corporation in 1993 appears, from the evidence, to have been for the purpose of reducing

Mead's apportionable income for state tax purposes.[3] This conclusion is supported by the following portions of Exhibits 35 and 37, which constitute statements, and therefore admissions, by Mead:

> It has been determined by Mead's Tax Department that a merger of Mead Data Central into Mead Corporation would result in substantial *state tax* savings. Estimated annual savings range from $1.2 million for 1994 increasing to $2.5 million by 2007 (based on current projections). The savings will occur primarily because Mead will be able to utilize net operating loss carryforwards which might otherwise expire unused.

(Exhibit 35; Joint Appendix, p. 147; emphasis added.)

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[3] Mead's actions might also be relevant for purposes of the "duty of consistency" doctrine. This Court has long held that general principles of estoppel apply to tax cases. *Stearns Co. v. United States*, 291 U.S. 54, 61-62 (1934) ["[N]o one shall be permitted to found any claim upon his own inequity or take advantage of his own wrong."]; *Magee v. United States*, 282 U.S. 432, 434 (1931) ["The taxpayer benefited by the claim and is not in a position to contest its legality."]. Simply stated, the duty of consistency prevents a taxpayer from taking one position on its tax return in one year, and a contrary position in a later year, after the statute of limitations has expired in the first year, to reduce its taxes in both years. Assuming Mead's strategy, of making Lexis into a division so it would be treated as unitary, succeeded in reducing its state taxes for one year, it would be inequitable to allow it to change its position in a subsequent year to reduce its taxes in that year.

CURRENT SITUATION

Mead Data Central Inc. and Mead Digital Systems, Inc. both operate as wholly-owned subsidiaries of Mead. Due to the stage of market development, the nature of their business, and similar matters; these two business units are not currently as profitable in relation to sales, assets employed and payroll as other segments of Mead. As separate corporations they pay state income taxes based on their *separate* corporate results. For U.S. income tax purposes, they are included in Mead's consolidated U.S. income tax return.

PROPOSED CHANGE

It is proposed that Mead Data Central Inc. and Mead Digital Systems, Inc. be liquidated/merged into Mead and be operated as separate divisions. As divisions of Mead, the financial results of their operations, *consolidated with the rest of Mead*, would result in a projected combined net *state income tax savings* of $3.0 to $5.0 million over the next five years.

(Exhibit 37; Joint Appendix, p. 149; emphasis added.)

Thus, according to the evidence, the merger allowed Mead to utilize net operating losses generated by one entity, which would otherwise have gone unused, by setting them off against the gains of another. Since the evidence shows that Mead's expectation was that the merger, and the use of the net

operating losses, would result in savings in state income taxes, one can reasonably draw the inference that the savings would be in the state income taxes imposed on Mead's apportionable income. Those savings, in turn, would obviously increase Mead's after-tax net profits. This increase would not have been just an increase in Mead's after-tax net income. The savings would have increased Mead's after-tax net *apportionable* income, thus providing a benefit to Mead's multi-state business operations.

Moreover, the impact on Mead's apportionable income was expected to be on-going. Thus, Mead's decision to merge Lexis into Mead resulted, or at least was expected to result in, an ongoing reduction in Mead's after tax apportionable income. To borrow this Court's language, the merger was not an "arm's length" transaction, and "the resulting flow of value is obvious." *Container*, 463 U.S. at 180, n. 19.

The evidence surrounding the purpose and nature of the merger is not only relevant in its own right. It also illustrates how other factors – in this case the manipulation of Mead's business structure – can be seen as relevant when they are viewed as part of the evidentiary background of a case. Consequently, this Court should reject Mead's effort to create categorical restrictions on what a trier of fact can consider.

IV. The Court Should Reject Mead's Implied Suggestion That The Burden Of Proof Should Be Shifted To The Tax Agency

In its brief Mead suggests that the State, rather than the taxpayer, bears the burden of proof, stating "assuming it were enough that the nonunitary asset served an operational function *even if* its sale did not (something this Court has never before endorsed), Illinois still could not satisfy that standard to justify taxing the sale." (Pet. Brief, p. 32; original emphasis.) Mead also states: "Illinois maintains that a putative taxing State has no obligation to show that 'the asset was utilized directly in the selling company's business.'" (Pet. Brief, p. 45.) Mead's effort to shift the burden of proof to the State is contrary to sensible and well-settled law.

This Court's precedents make it unmistakably clear that the burden of proof in apportionment cases is on the taxpayer. The taxpayer "has the burden of proof; it must demonstrate that there is 'no rational relationship between the income attributed to the State and the intrastate values of the enterprise.'" *Container*, 463 U.S. at 180; *see also*, *Mobil Oil*, 445 U.S. at 442, n. 16. This Court also explained that "[t]his burden is never met merely by showing a fair difference of opinion which as an original matter might be decided differently." *Container*, 463 U.S. at 176, quoting from *Norton Co. v. Department of Revenue*, 340 U.S. 534 (1951).

The imposition of the burden of proof on the taxpayer makes sense. It is the taxpayer who has control over the records and other information that reveal the nature of the taxpayer's business. The taxpayer can easily produce the documents and facts necessary to establish whether the various business segments under consideration operate as a single economic enterprise.

When a taxpayer files its return on a unitary basis, or stipulates to the ultimate fact that it is engaged in a unitary business, the State necessarily relies on that representation, and consequently does not pursue an audit of the underlying proposition (whether the taxpayer is engaged in a unitary business). The States' resources are limited and therefore States must be able to rely on a taxpayer's filing position, particularly so if the filing position is consistent for numerous years. Otherwise, States would be obligated to audit every issue for every year without regard to whether an issue is even in dispute.[4] This would be inefficient and unfair to state tax authorities, and would impose an unwelcome and intolerable burden on taxpayers, as well.

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[4] This point is illustrated by Mead's 1993 Illinois tax return. Mead filed on a unitary basis with Lexis/Nexis, as it had done since 1988, and derived whatever benefit arose from that position. Mead should be bound by its duty to consistently report the manner of treatment of items of income and expense, not only from year-to-year, but within the same year as well.

Assigning to the taxpayer the burden of proof is particularly justified in apportionment cases. As this Court has recognized, in the case of multi-state business enterprises, "arriving at precise territorial allocations of 'value' is often an elusive goal." *Container*, 463 U.S. at 164. For that reason, this Court has held that, "the taxpayer has the 'distinct burden of showing by clear and cogent evidence that [the state tax] results in extraterritorial values being taxed. . . .'" *Id.*

For years, state courts, taxing agencies, and taxpayers have relied on the fact that the burden of proof is assigned to taxpayers. For the reasons discussed above, an alteration of the burden of proof would be immeasurably disruptive.

V. Illinois Properly Determined That The Income Was Apportionable

When a component of an interstate business enterprise enhances that business' net after-tax *apportionable* income, there is a flow or transfer of value that evidences the "minimal connection" and "rational relationship" required by the Constitution, whether the component is viewed as being engaged in a "unitary relationship" or as serving an "operational function." In such a case, apportionment of the income generated by that component is properly apportioned along with the rest of the apportionable multistate income of the enterprise. A taxpayer challenging such apportionment has the burden to

prove that the "minimal connection" and "rational relationship" do not exist.

Here, the taxpayer did not meet its burden to show the absence of a minimal connection and rational relation between the activities of Mead and Lexis. In fact, such connections existed. The merger of Lexis into Mead was done for the purpose of setting off against the gains of one part of the business the losses incurred by another part, with the result that Mead expected an ongoing savings in its state income tax burden caused by the reduction in the amount of its apportionable income that would have been taxed. The expected decrease in that burden would have caused an increase in Mead's net after-tax apportionable income. Thus, there would indisputably have been a "flow of value" between Lexis and Mead. Lexis constituted an asset that was part of the unitary business of Mead, and upon its sale the gain from that sale was properly apportioned.

In addition, Mead incorrectly suggests that there was no operational function performed by Lexis because "the *sale* of Lexis/Nexis – i.e., the capital transaction Illinois seeks to tax – did not serve any operational function to Mead." (Pet. Brief, p. 32; original emphasis.) However, it is not the *sale* that indicates whether Lexis performed an operational function; it is how Lexis was operated and used while it was owned which matters.

The trial court and the Illinois appellate court concluded that the gain from the sale of Lexis was apportionable based on the evidence that, taken in

combination, demonstrates that the constitutional requirements are met. That conclusion is consistent with this Court's precedents, and should be affirmed.

CONCLUSION

For the reasons set forth above, amici curiae respectfully request that the Court affirm the Illinois appellate court's decision below.

Dated: December 7, 2007

Respectfully submitted,

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74 879a 22ps (G) No. 06-1413 13

IN THE

Supreme Court of the United States

MEADWESTVACO CORPORATION,
successor in interest to THE MEAD CORPORATION,
Petitioner,

v.

ILLINOIS DEPARTMENT OF REVENUE, DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE, and TREASURER OF THE STATE OF ILLINOIS,
Respondents.

On Writ of Certiorari to the Appellate Court of Illinois

BRIEF OF *AMICI CURIAE* COUNCIL ON STATE TAXATION AND NATIONAL ASSOCIATION OF MANUFACTURERS IN SUPPORT OF PETITIONER

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IN THE

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No. 06-1413

MEADWESTVACO CORPORATION,
successor in interest to THE MEAD CORPORATION,
Petitioner,

v.

ILLINOIS DEPARTMENT OF REVENUE, DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE, and TREASURER OF THE STATE OF ILLINOIS,
Respondents.

On Writ of Certiorari to the Appellate Court of Illinois

BRIEF OF *AMICI CURIAE* COUNCIL ON STATE TAXATION AND NATIONAL ASSOCIATION OF MANUFACTURERS IN SUPPORT OF PETITIONER

INTEREST OF *AMICI CURIAE*

This brief *amici curiae* in support of petitioner ("Mead") is filed on behalf of the Council On State Taxation ("COST") and the National Association of Manufacturers ("NAM").[1]

[1] The parties have consented to the filing of this brief. Counsel of record for all parties received notice at least 10 days prior to the due date of the *amici curiae*'s intention to file this brief. No counsel for a party authored this brief in whole or in part,

COST is a non-profit trade association formed in 1969 to promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. COST represents nearly 600 of the largest multistate businesses in the United States; companies from every industry doing business in every state. COST's members are concerned that Illinois' effort to tax the gain on the sale of a non-unitary, non-operational line of business will subject taxpayers to inconsistent and unconstitutional taxation. COST's members are also concerned that left unchecked Illinois' approach to taxing all income will lead other states to adopt similarly unsound theories of taxation, exacerbating multiple taxation of the same income.

NAM is the nation's largest industrial trade association, representing small and large manufacturers in every industrial sector and in all 50 states. The NAM's mission is to enhance the competitiveness of manufacturers by shaping a legislative and regulatory environment conducive to U.S. economic growth and to increase understanding among policymakers, the media and the general public about the vital role of manufacturing to America's economic future and living standards.

The Court has granted *certiorari* on this important case to review whether Illinois can tax the gain on Mead's sale of its investment in Lexis/Nexis, a non-unitary business that Mead held for investment purposes for twenty-six years. *Amici* represent multi-jurisdictional businesses that routinely hold invest-

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and no person or entity other than *amici curie*, their members, or their counsel has made a monetary contribution to the preparation or submission of this brief.

ments they neither closely manage nor incorporate into the unitary operations of the businesses. The frequency of these transactions and the large dollar amounts at stake (in this case a $1 billion gain) hyper-accentuate the importance of the rules for determining whether gains on such sales are apportionable income subject to tax by non-domiciliary jurisdictions. Certainty and protection against multiple taxation of such gains are critically important issues to all of *Amici*'s membership. *Amici*'s members have a strong interest in the Court standing beside what it has previously held to be allocable income that cannot be taxed by non-domiciliary jurisdictions.

STATEMENT OF THE CASE

Mead is in the business of producing and selling paper and packaging products along with office and school supplies. It was incorporated and commercially domiciled in Ohio. In 1968, Mead invested in Data Corporation by purchasing it for $6 million. In 1973, Data Corporation was transformed into Lexis and at that time it began providing electronic legal research at the national level. Nexis, a news and information service, was subsequently added to form Lexis/Nexis.

At various times Lexis/Nexis operated as a division or a subsidiary of Mead. Regardless of how Mead structured its Lexis/Nexis investment, Lexis/Nexis always maintained separate business operations, personnel and made no joint purchases with Mead. In December 2004, Reed Elsevier, P.L.C. bought Mead's Lexis/Nexis investment for approximately $1.5 billion.

Mead and its subsidiaries filed an Illinois combined unitary income tax return for the 2004 year reporting

that the $1 billion gain from its sale of Lexis/Nexis was nonbusiness income not allocable to Illinois. The Illinois Department of Revenue audited Mead's 1994 return and asserted that Mead's gain from the sale of Lexis/Nexis should be treated as business income subject to apportionment.

At the trial level, the Circuit Court of Cook County held that Mead and Lexis/Nexis were not unitary. However, the Circuit Court of Cook County held that Mead must apportion the gain because Lexis/Nexis served an operational purpose. On appeal to the Appellate Court of Illinois, First Judicial District, affirmed the Circuit Court of Cook County. Mead requested a Petition for Leave to Appeal with the Supreme Court of Illinois, which was denied on January 24, 2007.

This Court granted *certiorari* on September 25, 2007 to address the following question: Is the attempt by Illinois to tax the approximately $1 billion gain realized by Petitioner when it sold its interest in Lexis/Nexis in 1994 (which it acquired in 1968 for $6 million and which functioned for 26 years as an independent, nonunitary business) in direct conflict with the decisions of the Court in *Allied Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768 (1992), *F.W. Woolworth Co. v. Taxation & Revenue Department of New Mexico*, 458 U.S. 354 (1982) and *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982) and the Due Process and Commerce Clauses of the United States Constitution?

SUMMARY OF ARGUMENT

In the shaping decision of *Allied-Signal v. Director, Division of Taxation*, 504 U.S. 768 (1992), this Court contoured the outer reach of a state's ability to tax

multijurisdictional income to only those activities that bear a substantial relationship to the operations of the investor corporation in the state. The decision of the Appellate Court of Illinois severely undermines the *Allied-Signal* standard, exposing companies to extraterritorial taxation and unlimited apportionment.

Against the precedent established by this Court in *Allied-Signal,* Illinois is asserting that it can apportion investment income to the state that is not derived from a business's unitary operations. Income that serves an investment purpose must be allocated to Mead's commercial domicile, Ohio, and cannot be taxed by states in which Mead is carrying on its unrelated operations. As stated by this Court in *Allied-Signal*, "[s]tate legislators have relied upon our precedents by enacting tax codes which allocate intangible nonbusiness income to the domiciliary State . . . [w]ere we to adopt New Jersey's theory, we would be required either to invalidate those statutes or authorize what would be certain double taxation." *Id.* at 785. If the Illinois case is left unfettered, the Constitutional limitations described in *Allied-Signal* will be ignored and states will be free to tax income earned outside their borders. The Court espoused in *Quill v. North Dakota*, 504 U.S. 298 (1992), "the benefits of a clear rule . . . firmly establishes the boundaries of legitimate state authority to impose . . . taxes and reduces litigation concerning those taxes." Absent such a rule, interstate commerce will suffer grievous harm. *Id.* at 315.

ARGUMENT

I. *ALLIED-SIGNAL'S* OPERATIONAL VERSUS INVESTMENT FUNCTION TEST APPLIES ONLY IN THE CONTEXT OF NON-CONTROLLED BUSINESSES

The taxation of multistate activity, and in particular the rules by which non-domiciliary states may tax income from the liquidation or sale of major assets, has routinely attracted the attention of this Court. *See, e.g.*, *Allied-Signal*, 504 U.S. 768; *ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307 (1982); *F.W. Woolworth Co. v. Taxation & Revenue Dep't of the State of New Mexico*, 458 U.S. 354 (1982). This Court's previous guidance establishes the Constitutional boundaries for fair taxation of businesses whose activities cross state lines. By doing so, the Court has carefully crafted a set of rules that protect interstate commerce from discrimination and that provide clear guidance such that state and local taxes do not unlawfully impede economic growth. While the scope of the Constitutional limits on state taxation was not always clear, this Court brought a measure of certainty to the arena of state tax in the seminal case of *Mobil Oil Corp.* v. *Commissioner of Taxes of Vermont*, 445 U.S. 425, 439 (1980), where it clarified that "[The] linchpin of apportionability in the field of state income taxation is the unitary business principle." *See also Exxon Corp. v. Department of Revenue of Wisconsin*, 447 U.S. 207 (1980).

Two years after *Mobil Oil*, the concept of the unitary business enterprise was further clarified in two cases decided on the same day, *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307 (1982) and *F. W. Woolworth Co. v. Taxation & Revenue Department of New Mexico*, 458 U.S. 354 (1982). In

these two decisions the Court struck down attempts by two states to tax an apportioned share of income, which was—similar to the present case—derived from a non-unitary business. In reaching its decision the Court indicated that actual, and not merely potential, control of another enterprise is required to establish a unitary relationship, and further emphasized that a unitary inquiry requires a review of three factors: "(1) functional integration; (2) centralization of management; and (3) economies of scale." *Id.* at 362, 364.

When read together, these cases establish an overarching policy that binds the apportionability of income directly to whether the income stems from a unitary function of the business sought to be taxed. In other words, a state need not attempt to isolate the intrastate income-producing activities from the rest of the business; it may tax an apportioned sum of the corporation's multistate business if the business is unitary.

Ten years after *ASARCO* and *Woolworth*, and in response to an argument by New Jersey that all income was subject to apportionment, this Court upheld the unitary principle, acknowledging that some income from a nonunitary enterprise might be apportionable—if "the capital transactions serve an operational rather than an investment function." *Allied-Signal v. Director, Div. of Taxation*, 504 U.S. 768, 787 (1992).[2] The Court first articulated the application of

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[2] In *Allied-Signal*, this Court specifically declined the invitation of the State of New Jersey that "the unitary business principle must be abandoned in its entirety, arguing that a nondomiciliary State should be permitted 'to apportion all the income of a separate multistate corporate taxpayer.'" *Allied-Signal* at 784. The Court rejected the idea that all income of an enterprise should be taxable in every state; an idea which it

an operational function concept to state tax apportionment regimes in *Container Corp. of America v. Franchise Tax Board.*, 463 U.S. 159 (1983). In *Container Corp.*, the Court examined the sole issue of whether a unitary relationship existed between wholly-owned entities. The Court cited *Corn Products Co. v. Commissioner*, 350 U.S. 46 (1955), as an example, "in another context," of how "capital transactions can serve either an investment function or an operational function." *Container Corp.*, 463 U.S. at 180 n.19. Although the *Container Corp.* footnote discusses what would later evolve into the operational function test in *Allied-Signal*, the issue in *Container Corp.* related solely to the unitary business. *See id.* at 178 (observing that the parent and subsidiary were "engage[d] in the same line of work" so that the subsidiary supported the parents "through economies of scale or through operational integration or sharing of expertise").

The lineage of the operational function test suggests that the sale of a nonunitary asset may satisfy the operational function test only where a taxpayer has the ability to control the nonunitary asset but does not. *Allied-Signal*, *Woolworth*, and *ASARCO* support such a conclusion. The Court in *Allied-Signal* analyzed a "capital transaction," that "serve[s] an operational rather than an investment function." *Allied-Signal*, 504 U.S. at 787. Allied-Signal owned 20.6% of the business it sold. As such, it did not control the sold business and, as a result, did not have a unitary relationship with the sold business. Nevertheless, this Court made clear that the absence of control did not prevent a finding that Allied-

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acknowledged would obliterate the apportionable income concept. *Id*

Signal's gain was apportionable income. The operational versus investment function test was applied by this Court *only* in the circumstance where control did not exist. *Compare Allied-Signal*, 504 U.S. at 773 (applying operational functional test where 20.6% ownership) *with ASARCO Inc. v. Idaho State Tax Commission,* 458 U.S. 307 (1982) and *F. W. Woolworth v. Taxation & Revenue Department of New Mexico,* 458 U.S. 354 (1982) (applying only a unitary analysis where ownership was 100%).

Thus, this Court should make clear that the operational versus investment function test applies only in those narrow circumstances where the ability to control a nonunitary business is absent. Such ability to control is present here and the test should not be applied.

II. THE ILLINOIS APPELLATE COURT'S MISAPPLICATION OF THE OPERATIONAL VERSUS INVESTMENT FUNCTION TEST WOULD RENDER ALL INCOME SUBJECT TO APPORTIONMENT

Even if the operational function test applies in this instance, the Illinois appellate court expanded this Court's operational function test in such a way that nearly every corporate investment will serve an operational purpose under its application. While *Allied-Signal* does not list a series of specific factors to consider under the operational test, this Court has only narrowly applied the test by focusing on whether the asset generating the income was utilized directly in the selling company's business, or whether it was utilized for investment purposes to fund the day-to-day working capital and operations of the selling company. *Id.* at 787, 789-90. Only if one of these

functions is met can the income be determined to be operational and subject to tax by a non-domiciliary jurisdiction.

The Appellate Court of Illinois erroneously adopted its own test in place of the operational analysis required by *Allied-Signal*. The Appellate Court of Illinois focused on a series of irrelevant and results-oriented factors intended to accomplish implicitly what New Jersey attempted explicitly in *Allied-Signal*—to eliminate any limitations on apportionment.

While this Court did not set forth a monolithic test in *Allied Signal* on what constitutes income from an operational function, this Court did provide one narrow example of income that serves an operational function. Interest earned on short-term deposits at a bank used for the working capital of a unitary business serves an operational function, and accordingly could be subject to apportionment. *Allied Signal* at 787.

The Court has also implied that the same holds true with long-term investments if the investment "serves the primary function of diversifying the corporate portfolio and reducing the risks inherent in being tied to one industry's business cycle." *Container Corp.*, 463 U.S. 159 at 178.

It can be inferred from *Allied-Signal* and *Container Corp.* that the narrowly crafted test for whether income was received from an operational function of the business is: (1) was the income derived from an asset that was used in the business's unitary operations or (2) was the income a component part of the business's working capital. If either of these is true, then the income serves an operational function and can be part of the corporation's unitary apportion-

ment. In contrast, if both are answered in the negative, then the income is an investment function that is only subject to taxation by the domiciliary state.

As described below, the factors utilized by Illinois to conclude that the gain was apportionable disregard the necessary operational focus this court established in *Allied-Signal*—whether the asset was used in the same line of business as the company that sold it or whether the asset was analogous to working capital. By substituting its own factors the Illinois court instead focuses the analysis on criteria that would support the conclusion that the gain on the sale of *any* business investment will be subject to apportionment. In a rather self-serving fashion, the court below evaluated factors that exist as a matter of normal business practice for nearly all corporate investments and which make the elimination of non-apportionable income a *fait accompli*.

The Opinion of the Appellate Court of Illinois ("*Op.*"), includes the following factors that, as also set out below, have no bearing on whether the asset being held is operational:

> (i) "Mead considered Lexis/Nexis in its strategic planning, particularly in the allocation of its resources." *Op.* at 117.

Strategic planning about asset holdings, including a determination of where a parent company should invest additional resources, reflects analytic thought about the asset owner's financial investment strategy and thus supports a conclusion that the corporate holding serves an investment purpose, not an operational purpose. Indeed, strategic planning about the allocation of a company's resources is a fiduciary obligation of the directors and officers of the com-

pany, and failing to undertake this responsibility could subject those leaders to shareholder suits. Giving such planning adverse state tax consequences places management in a conflicted and untenable position.

> (ii) "Mead was 100% owner of Lexis/Nexis." *Op.* at 118.

100% ownership of a subsidiary does not by itself create a unitary relationship. While the percentage of ownership is relevant in determining whether a unitary relationship exists, it does not demonstrate that the asset serves an operational purpose. Corporations buy and sell subsidiaries, assets, divisions, and lines of business every day. Some of these transactions may be for operational synergy; others serve strictly an investment purchase—to hedge against market conditions, or simply to invest excess capital. The fact that Mead owned Lexis/Nexis in its entirety for many years does not demonstrate an operational (or investment) relationship. Mead had the potential to operate Lexis/Nexis as part of its unitary business; however, Mead elected not to do so and allowed Lexis/Nexis to function both autonomously and independently from itself, see *Woolworth*, 458 U.S. 358 at 364.

> (iii) "Mead developed Lexis/Nexis by contributing capital support until it became profitable." *Op.* at 118.

This factor is irrelevant; it does not demonstrate that there was either an investment management strategy or an operational relationship. The fact that an investor would contribute additional working capital to one of its corporate holdings demonstrates sound investment management designed to guard the investment from capital shortfalls or promote the

growth of that investment. It is normal when investing in a new business for the investment to take several years before it can sustain itself and, hopefully, become a profitable investment. In the interim period, it is not unusual for an investor to have to contribute additional capital to keep the investment in the business afloat or to increase one's overall return. Thus, Mead's investment strategy to infuse capital into Lexis/Nexis until it became profitable mirrors and is completely compatible with the investment serving an investment function for Mead. In addition, proper fiduciary management of investments requires that they be adequately capitalized; often the success or failure of an investment depends on its capitalization.

> (iv) "Mead continued to approve major capital expenditures by Lexis/Nexis." *Op.* at 118.

The fact that an investor retains decision-making power over major capital expenditures again demonstrates sound investment management designed to ensure that the investment owner's interests are adequately protected. As stated above, this point was also rejected by this Court in *Woolworth*. Absent an exertion of actual control by Mead, Mead's ability to exert its potential control over Lexis/Nexis operations did not equate into Mead's investment in Lexis/Nexis turning Lexis/Nexis into a part of the unitary enterprise and did not convert Lexis/Nexis into an operational function. Occasional oversight in an investment also does not destroy the investment nature of a business. Certainly, investors have a right, if not a duty, to verify management is making sound business decisions.

(v) Mead "manipulated Lexis/Nexis' business organization, treating it as either a division or a corporate subsidiary". *Op.* at 118.

Companies across the country routinely change their corporate structure to account for market changes. The tax and non-tax related reasons for routine changes in corporate structure are nearly infinite. The fact that Lexis/Nexis at the time Mead disposed of its investment in Lexis/Nexis operations was a division of Mead is also not a determining factor to allow Illinois to apportion the gain from Mead's sale of Lexis/Nexis. As stated by the Court in *Mobil*, 445 U.S. at 440, citing *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 at 444, "At the onset, we reject the suggestion that anything is to be gained by characterizing receipt of the dividends as a separate taxable event . . . [such] tags of this kind are not instruments of adjudication but statements of result" (internal quotes omitted).

The Court went on further to state in *Mobil*, 445 U.S. 425 at 440, that "One most look principally at the underlying activity, not the form of investment, to determine the propriety of apportionability." The Court stated, "[T]he form of business organization may have nothing to do with the underlying unity or diversity of [the] business enterprise." *Id.* at 440. See also *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 at 168.

This conclusion is important because in today's business environment businesses choose many different ways of owning their investments. Whether the return on an investment is from a subsidiary, a division, a partnership, or some other form of ownership, the determination regarding whether the

income from the investment necessitates apportionment or allocation should be the same.

> (vi) "Mead retained tax benefits and control over Lexis/Nexis' excess cash." *Op.* at 118.

It should be understood that investors put their money in investments with the goal of retaining tax benefits and excess cash produced by the investment. A test on whether income serves an operational or investment function based on a business having some tax benefits (or detriments) is plainly erroneous. Such a test must focus on how the property was used. If the tax benefit is derived from assets used in the business's unitary operations, clearly that is income subject to apportionment by a non-domiciliary state. However, as in Mead's situation, where the asset generating the income is not part of its unitary group or otherwise used to support its unitary operations, the income is solely serving an investment function. This position is also supported by the Supreme Court of California in its analysis of cases from California's State Board of Equalization, See *Hoechst Celanese Corp. v. Franchise Tax Board*, 22 P.3d 324 at 341-342 (Cal.), *cert denied*, 534 U.S. 1040 (2001).

> (vii) Mead, in its 1993 annual report, "identified itself as 'the developer of the world's leading electronic information retrieval services for law, patents, accounting, finance, news and business information'"; and, in its "1993 10-K form, Mead described itself as engaged in electronic publishing and included Lexis/Nexis in its discussion of business segments rather than its 'investees.'" *Op.* at 118.

Corporate Annual Reports and 10-K's aim to provide shareholders with information about the company itself as well as information about all of its

investment holdings. The fact that the Annual Report and 10K identified the company "itself" as being in the electronic information business is simply a reflection of the fact that the report discloses all signif ant holdings, divisions and lines of business of the combined group of related entities. This cannot be a factor in determining whether the corporate holding is operational.

The factors used by the Illinois court, when taken together, describe activities that any investor would sensibly conduct to protect asset value. As such, those factors blur the operational analysis inextricably with investment function analysis. At the heart of the Illinois court's faulty "operational" analysis, in light of common investment practices, is a goal of subjecting multi-jurisdictional businesses gains from the sale of *any* investment to apportionment by a multitude of non-domiciliary states if such states can show that the investor: (1) exercised normal due diligence; (2) had the mere potential to exercise some level of control; (3) engaged in strategic planning; (4) continued expansion of the investment if necessary; (5) controlled how the investment is held or titled; (6) decided whether to retain tax benefits or excess cash created by the investment; and, (7) worst of all, if the investor managed to do well by the investment and noted that fact in its Annual Report or 10-K.

The "operational" activities that Illinois considers relevant are synonymous with normal investment practices reflecting the due diligence necessary to protect and nurture the value of any investment. This type of stewardship is not symptomatic of the control and utilization inherent in the operational relationship required by *Allied-Signal*. Illinois should

not be allowed to blur operational analysis simply by substituting factors that demonstrate sound investment practice. To do so obliterates the operational standard altogether and will have the effect of subjecting investment gains from non-unitary holdings to multiple and discriminatory taxation.

Clear guidance from the Court is requested to prevent unfair and duplicative taxation by the states of the same income. This is not only an important issue to businesses to correctly determine their tax liabilities and properly report their finances, but it is also vital to the state and local governments to have some certainty with their revenue streams. As the Court has heeded in the past, it does not want to "disrupt settled expectations in an area of law in which the demands of the national economy require stability." *Allied-Signal* at 786. Illinois' determination that Mead's investment in Lexis/Nexis served an operational function effectively eviscerates the concept of some income having an investment function.

The Court's clear guidance in this area is of additional import because several states, including Illinois, have taken positions that all income will be subject to apportionment to the full extent allowed under the United States Constitution. According to a chart for determining nonbusiness income published by CCH Incorporated, presently three states have laws that explicitly require the apportionment of all income earned by a business to the greatest extent possible under the United States Constitution.[3] This

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[3] *Determining Nonbusiness Income*, Multistate Charts (CCH-EXP) ¶600-320, *available at* CCH Tax Research, State Tax-Multistate Publication-Multistate Quick Answer Charts. Those states are Illinois, Minnesota, and North Carolina. Three other

Court has established limits to a state's power to tax income that is not unitary to a company's operations and which does not serve an operational function. To maintain stability and predictability in knowing what income can be apportioned, the Court should reverse Illinois' determination that the gain from the sale of a long-term investment in Lexis/Nexis served an operational function.

CONCLUSION

Illinois' attempt to undermine *Allied-Signal* must be halted by this Court. *Allied-Signal* provides the outer limits on the income derived from a non-unitary operation that a state can tax based on a substantial connection to the unitary operations of the business. Clear guidance is also needed to prevent future interpretations by non-domiciliary states asserting they can tax income from a non-unitary operation that does not serve an operational function to the unitary business.

RELIEF REQUESTED

The Council On State Taxation and the National Association of Manufacturers respectfully requests that this Court reverse the decision of the Appellate Court of Illinois, First Judicial District. This Court's guidance on what income a state can tax on an apportioned basis versus allocation to the state of commercial domicile will prevent businesses from multiple taxation of the same income.

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states with similar laws that presume all income should be apportioned are Connecticut, Nebraska and New Hampshire.

Respectfully submitted.

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In The
Supreme Court of the United States

MEADWESTVACO CORPORATION, successor in interest to THE MEAD CORPORATION,

Petitioner,

v.

ILLINOIS DEPARTMENT OF REVENUE, DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE, AND TREASURER OF THE STATE OF ILLINOIS,

Respondents.

On Writ Of Certiorari To The Appellate Court Of Illinois

AMICUS CURIAE BRIEF IN SUPPORT OF PETITIONER, MEADWESTVACO CORPORATION, SUCCESSOR IN INTEREST TO THE MEAD CORPORATION, SUBMITTED ON BEHALF OF GANNETT CO., INC.

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QUESTION PRESENTED

Is the attempt by Illinois to tax the approximately $1 billion gain realized by Petitioner when it sold its investment in Lexis/Nexis in 1994 (which it acquired in 1968 for $6 million and which functioned for 26 years as an independent, nonunitary business) in direct conflict with the Due Process and Commerce Clauses of the United States Constitution and the decisions of the Court?

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INTEREST OF THE *AMICUS CURIAE*[1]

Pursuant to Rule 37.2 of the Rules of this Court and this Court's Order dated September 25, 2007, Gannett Co., Inc. ("Gannett") respectfully submits this brief as *amicus curiae* in support of Petitioner MeadWestvaco Corporation ("Petitioner").

Gannett is the parent corporation of an affiliated group of corporations and other business entities with operations in the United States, the United Kingdom, and elsewhere. Gannett is a leading international news and information company. In the United States, the company publishes 85 daily newspapers, including *USA TODAY*, and nearly 1,000 non-daily publications. The company is the largest newspaper publisher in the United States, and also operates Internet sites offering news and information customized to the market served. In addition, Gannett carries on publishing operations in the United Kingdom, operating as Newsquest, including 18 daily newspapers and almost 300 non-daily publications. Gannett's other principal business segment is its broadcasting segment that operates 23 broadcast television stations in the United States with a market reach of over 20.1 million households.

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[1] No counsel of a party authored this brief in whole or in part, and no person or entity, other than the *amicus curiae*, made a monetary contribution to the preparation or submission of this brief. All parties have consented to the filing of this brief, and the letters of consent of both Petitioner and Respondents have been filed with the Court pursuant to Rule 37.2(a).

As a publicly traded corporation, Gannett must file various public documents with the Securities and Exchange Commission ("SEC"). Like all public companies, Gannett must determine its business segments and report these in its public financial statements filed with the SEC. Currently, Gannett has determined that its largest business segment is newspaper publishing and its other business segment is television broadcasting. Although newspaper publishing has always been Gannett's largest segment, in the past it has operated other reportable business segments, including outdoor advertising and cable television.

Like any responsible parent corporation, Gannett approves its subsidiaries' capital budgets and may contribute capital to its newspapers, television stations, and internet businesses whether they are in start-up mode or mature. Likewise, Gannett maintains a cash management system to facilitate sound financial accounting controls for cash and accurate quarterly reporting of Gannett's cash position in SEC filings.

Gannett is presently involved in litigation in a number of States, including Illinois, Maine, and Montana. This litigation presents questions regarding the proper state income tax treatment of capital gains recognized by a subsidiary of Gannett that disposed of a cable television business that Gannett acquired in December 1995 as part of its acquisition of Multimedia, Inc., and held for a little over four (4) years before selling the assets to Cox Communications, Inc.

in January 2000. The issue is also the subject of ongoing controversies that may eventually be litigated in several additional States.

Gannett believes that the Illinois Appellate Court's decision below improperly interpreted this Court's "operational versus investment function test" in a way that effectively removes the unitary business principle, in general, and specifically, the operational function test, as a meaningful limitation on the reach of States to tax the income of non-domiciliary taxpayers from interstate business activities. This is a field in which Gannett has a major interest.

SUMMARY ARGUMENT

The decision of the Illinois Appellate Court should be reversed, because that court erroneously held that evidence of corporate stewardship and oversight was sufficient to find the operational function requirement satisfied. The lower court also failed to appreciate the significance that diversity in lines of business should have in determining whether one line of business serves an operational function for the activities of a different, diverse line of business.

One of the key functions of management when serving as responsible corporate stewards for shareholders of a public company is financial oversight and transparent financial reporting. Among the common oversight roles of management are approval of capital budgets, cash management, and financial statement

reporting in accordance with promulgated standards. Management may also alter a subsidiary's capital structure and an affiliated group's organizational structure for a variety of reasons having nothing to do with operations, such as to limit legal liability or maximize its return on assets. The Illinois Appellate Court thought these standard stewardship and oversight activities caused the assets of a diverse business segment to serve an operational function for its corporate owner and, therefore, the lower court's decision should be reversed.

In addition to Petitioner's stewardship and oversight, the Illinois Appellate Court found an operational function because the lower court believed Petitioner was not a passive investor, and because Petitioner held greater than a minority investment in Lexis/Nexis. This reasoning says nothing of whether the Lexis/Nexis assets were used in or operationally related to Petitioner's paper, packaging, office and school supply business activities carried on in Illinois and elsewhere. Further, the Illinois Appellate Court was persuaded by Petitioner's business segment reporting of Lexis/Nexis in its annual and interim public financial reports to shareholders pursuant to standards promulgated by the Financial Accounting Standards Board ("FASB"). FASB's mission is to establish and improve financial accounting and reporting. The FASB standards promote financial transparency for shareholders, investors and the capital markets. However, the precedents of this Court, not FASB pronouncements, should determine

when an investment serves an operational or investment function. Petitioner's reporting of Lexis/Nexis as a separate business segment emphasizes the differences between Lexis/Nexis and Petitioner's other businesses. As a result, this reporting is consistent with this Court's precedents and the nonoperational use and relationship of Lexis/Nexis to Petitioner's other businesses.

ARGUMENT

I. THE TEST OF OPERATIONAL FUNCTION SHOULD REQUIRE AN INQUIRY INTO WHETHER DISPOSED ASSETS WERE USED IN OR OPERATIONALLY RELATED TO UNITARY BUSINESS ACTIVITIES IN THE TAXING STATE.

The "operational versus investment function test" is an alternative test or means by which a taxing State may reach the income of interstate business activities in the absence of a direct unitary relationship between an investor and investee (or payee and payor of income). *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 787 (1992). Therefore, in the absence of a direct unitary business relationship, a State may still tax income from interstate business activities consistent with the unitary business principle of the Due Process and Commerce Clauses if "the capital transaction serve[d] an operational rather than an investment function." *Allied-Signal*, 504 U.S. at 787.

Although an alternative test, the "operational versus investment function test" complements the unitary business principle. That is, it is also a " . . . necessary limit on the States' authority to tax value or income that cannot in fairness be attributed to the taxpayer's activities within the State. It is this second component, the necessity for a limiting principle, that underlies this case." *Allied-Signal*, 504 U.S. at 780. Thus, "the relevant unitary business inquiry, [is] one which focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State." *Id.* at 785. *See also Allied-Signal*, 504 U.S. at 793 (O'Connor, J. dissenting) ("Whether an investment is short-term or long-term, what matters for due process purposes is whether the investment is operationally related to the in-state business.") None of the factors relied on by the Illinois Appellate Court show that the Lexis/Nexis assets were used in or operationally related to Petitioner's unitary business activities in Illinois so as to be an "integral operational" part of those activities. *Allied-Signal*, 504 U.S. at 788.

For instance, in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983), the taxpayer's loans and loan guarantees served an operational function because they helped the taxpayer's overseas operations to continue growing and "to become a more substantial part of the" activities of the taxpayer's vertically integrated enterprise. 463 U.S. at 180, n. 19. In *Container* this Court also noted that *Corn Products Refining Co. v. Commissioner*, 350

U.S. 46 (1955), was "another context [where] capital transactions can serve either an investment function or an operational function." *Id.* In *Corn Products*, corn futures hedging transactions were held to result in recognition of ordinary income not capital gains, as the futures transactions were integrally tied to the taxpayer's ordinary business activities. The taxpayer was engaged in the business of converting corn into starches, sugars, and other products and hedged corn purchases to assure itself a steady supply of corn and to protect itself against price increases. Conversely, financial oversight, such as that related to capital structure, debt, and dividends found in *F.W. Woolworth Co. v. Taxation & Revenue Department of New Mexico*, 458 U.S. 354 (1982), did not rise to the level of an operational function. *Container*, 463 U.S. at 180, n. 19. Among other factual stipulations relevant to the Court's holding in *Allied-Signal*, the parties had stipulated that "[n]one of Asarco's activities, businesses or income (in New Jersey or otherwise) were related to or connected with Bendix's activities, business or income (in New Jersey or otherwise)." *Allied-Signal*, 504 U.S. at 774.

Therefore, *amicus curiae* Gannett respectfully submits that whether a tangible or intangible asset of a nondomiciliary corporation serves an operational or investment function should be determined by focusing on whether the asset is used in or operationally related to the business activities of the investor carried on in the taxing State and elsewhere.

Petitioner was in the business of producing and selling paper, packaging, office and school supplies. J.A. 9. Lexis/Nexis provided online information services for legal, news and financial information in the electronic publishing market. J.A. 10. Prior to the sale, Lexis/Nexis was merged into and became a division of Petitioner. J.A. 14. In December, 1994, the sale of Lexis/Nexis to Reed Elsevier plc was completed. J.A. 14. The Illinois Appellate Court should have inquired into whether the Lexis/Nexis assets owned by Petitioner were used in Petitioner's paper, packaging, office and school supply business activities carried on in Illinois, as opposed to whether Petitioner approved Lexis/Nexis capital expenditures, "swept" cash from Lexis/Nexis, reported Lexis/Nexis on its public financial statements as a principal business segment, or altered Lexis/Nexis' capital structure or place on the corporate organization chart. As a result of its focus on these unrelated factors, the Illinois Appellate Court was not properly focused "on the objective characteristics of the [Lexis/Nexis] asset's use and [their] relation to the [Petitioner] and its activities within the taxing State" of Illinois. *Allied-Signal*, 504 U.S. at 785.

For example, Lexis/Nexis was not acquired to nor did it provide a source of supply or raw materials for Petitioner's paper, packaging, office and school supply business activities carried on in Illinois and elsewhere. It was also not acquired to nor did it serve as a distribution outlet for Petitioner's products in Illinois and elsewhere. Lexis/Nexis also was not

acquired by Petitioner to nor did it provide research and development or other services related to Petitioner's business activities in Illinois and elsewhere. Petitioner held the Lexis/Nexis assets as an investment in a diverse business enterprise, not as an operational part of its business.

A. Whether an Investment is Passive or a Minority Interest does not have Direct Relevance to Whether the Operational Function Test is Satisfied.

At various times during the 26 years that Lexis/Nexis was owned by Petitioner, Lexis/Nexis was held as a wholly-owned subsidiary or as an unincorporated division of Petitioner. The varying forms of ownership should not matter as the substance of the relationship between Lexis/Nexis and the Petitioner never changed. Nonetheless, the Illinois Appellate Court was influenced by Petitioner's ownership interest in Lexis/Nexis, and that court's view of Petitioner's role as more than that of a passive investor. Pet. App. 12a-13a. This sheds no light on whether Petitioner's use of Lexis/Nexis was operationally related to Petitioner's paper, packaging, office and school supply business activities in Illinois and elsewhere.

A passive investment does not represent an operational function for the holder of the investment because a passive investor does not use the assets in its business. However, the converse is not true. An investment could serve a nonoperational function for

the investor without being passive. For example, nonoperational cash investments could be managed by an investment bank, or actively managed by a taxpayer, and remain nonoperational investment assets.[2] Likewise, a minority investment is a mere label and says nothing of whether it serves an operational or investment function for the investor. An investment being held and overseen so that it does not waste and that is sold when the market is right or the desired offer is received is not being used in any business activity and serves an investment function of the investor whether the investor owns a minority interest or 100 percent. As this Court stressed in *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 440 (1980), "[o]ne must look principally at the underlying activity not at the form of investment, to determine the propriety of apportionability." The factors relied on by the Illinois Appellate Court did not consider whether the Lexis/Nexis assets were used in or operationally related to Petitioner's unitary paper, packaging, office and school supply business activities conducted in Illinois.

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[2] *See Home Interiors and Gifts, Inc. v. Dept. of Revenue*, 741 N.E. 2d 998 (Ill. App. Ct. 2000).

B. Capital Expenditure Approval, Capital Contributions, Cash Management, and Capital or Organizational Structure Changes Serve Oversight or Stewardship Functions, not Operational Functions.

Petitioner's approval of Lexis/Nexis capital expenditures, contributions of capital, segment reporting of Lexis/Nexis in its public company financial statements, cash management system, and "manipulation" of capital and organization structure, in addition to being common to any public company, did not, by themselves or in combination, create any operational relationship for the Lexis/Nexis assets to Petitioner's Illinois business activities. Nonetheless, the Illinois Appellate Court found that Lexis/Nexis served an operational function for Petitioner solely on the basis of these common stewardship and oversight factors. Pet. App. 2a-4a, 11a-13a. These factors simply are no more than representative of "the type of occasional oversight – with respect to capital structure, major debt, and dividends – that any parent gives to an investment in a subsidiary, . . . " *F.W. Woolworth*, 458 U.S. at 369.

For example, the Illinois Appellate Court emphasized Petitioner's cash management system, which was a nightly cash "sweep" of Lexis/Nexis bank accounts to a concentration account of Petitioner. Pet. App. 3a. A cash management system is critical to a public company and promotes accounting control of cash to facilitate accurate quarterly reporting of the

company's cash position in SEC filings. In civil tax cases, unencumbered cash advances are treated as constructive dividends by the operating subsidiary to the parent corporation to the extent of the subsidiary's earnings and profits (and as a return of capital to the shareholder to the extent in excess of the subsidiary's earnings and profits). Alternatively, the cash advances may be treated as a loan if, based on a variety of factors, it is the intent of the parties that the advances be repaid. *Alterman Foods, Inc. v. United States*, 505 F. 2d 873 (*Alterman I*) (cash advances made "on demand" to parent treated as dividends); *Alterman Foods, Inc. v. United States*, 611 F. 2d 866 (Ct. Cl. 1979) (*Alterman II*) (bi-weekly cash transfers from out-of-state subsidiary bank accounts to parent's account treated as dividends); *New York Times Sales, Inc. v. Commissioner of Revenue*, 667 N.E. 2d 302 (Mass. App. Ct. 1996) (daily cash "sweeps" pursuant to cash management system from subsidiaries to parent treated as dividends). A distribution needs not be formally declared or constitute a dividend under state law to be treated as a dividend for tax purposes. *New York Times Sales*, 667 N.E.2d at 305 (citations omitted). Rather, "a distribution of property . . . made by a corporation with respect to its stock" of its accumulated and current earnings and profits is a dividend for tax purposes. 26 U.S.C. §§ 301(a), (c)(1), and 316(a). A dividend is simply a distribution of available earnings or profits under a claim of right without any expectation of repayment. *Clark v. Commissioner*, 266 F. 2d 698, 711 (9th Cir.

1959); *Livernois Trust v. Commissioner*, 433 F. 2d 879, 883 (6th Cir. 1970).

Granted, when Lexis/Nexis became a division of Petitioner, the nightly cash "sweep" could not have been a dividend distribution for tax purposes, as it would not have been a "distribution . . . by a corporation with respect to its stock." Instead, the "sweep" would have been an intra-divisional transfer of funds. Nonetheless, insofar as the operational function is concerned, this distinction should be of no constitutional significance. However viewed, the nightly cash "sweep" was a commingling of cash advances. This Court previously held that a commingling of dividend income does not have unitary significance because that "subverts the unitary-business limitation," *F.W. Woolworth*, 458 U.S. at 364, n. 11. Likewise, when the Illinois Appellate Court relied on Petitioner's cash management system as serving an operational function it subverted the unitary business limitation. The nightly cash "sweep" was invested by Petitioner for the benefit of Lexis/Nexis. J.A. 181-182. The net excess cash returned to Petitioner by the nightly cash "sweep" over the course of time was a dividend or return on its investment, but does not tell "whether in pursuing maximum profits" for Lexis/Nexis or itself "[Petitioner] treated particular intangible assets as serving, on the one hand, an investment function, or, on the other, an operational function." *ASARCO Inc. v. Idaho State Tax Comm.*, 458 U.S. 307, 328 (1982); *Allied-Signal*, 504 U.S. at 785.

A cash management system furthers the corporate or business purposes of cash accounting and reporting, maximizing profits and facilitating the movement of cash among subsidiaries or operating divisions. Even though investments or activities may serve such important purposes, these consistently have been rejected by this Court as having unitary or operational function significance. *Allied-Signal*, 504 U.S. at 788; *F.W. Woolworth*, 458 U.S. at 363; and *ASARCO*, 458 U.S. at 326.

C. Segment Reporting Serves a Management Oversight Function.

Petitioner included Lexis/Nexis as a "reportable business segment" in Petitioner's 1993 SEC Form 10-K and Annual Report to Shareholders. J.A. 83, 120. The Illinois Appellate Court found it was significant that Lexis/Nexis was described in Petitioner's annual reports as a business segment and not as an "investee." Pet. App. 13a.

In accordance with Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information* (1997), issued by the Financial Accounting Standards Board ("FAS 131"), all "public business enterprises" are required to report certain information about operating segments in annual financial statements and interim financial reports issued to shareholders. FAS 131, at 4. The objective of FAS 131 is to provide information about the different business activities in

which a public company engages and the different economic environments to help users of the public company's financial statements. FAS 131, at 5, ¶ 3. If an "operating segment" satisfies certain "quantitative thresholds," then it is a "reportable business segment."[3] FAS 131, at 8-9, ¶¶ 16, 18. FAS 131 became effective for fiscal years beginning after December 15, 1997, and superseded Statement of Financial Accounting Standards No. 14, *Financial Reporting for Segments of a Business Enterprise* (1976) ("FAS 14"), and related financial accounting pronouncements. FAS 14 and related pronouncements generally required public business enterprises to report segment information by industry and geographic area.

"Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by the

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[3] In general, an "operating segment" is defined to mean "a component of an enterprise" that (1) "engages in business activities from which it may earn revenues and incur expenses . . . ", (2) "whose operating results are regularly reviewed by the enterprise's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance," and (3) "for which discrete financial information is available." FAS 131, at 7, ¶ 10. The "quantitative thresholds" that make an "operating segment" a "reportable business segment" are reported revenues that are at least 10 percent of combined revenues of all operating segments, reported profit or loss that is at least 10 percent of combined profit of segments reporting profits or 10 percent of combined loss of segments reporting losses, and assets that are at least 10 percent of combined assets of all operating segments. FAS 131, at 9, ¶ 18.

chief operating decision maker in deciding how to allocate resources and in assessing performance." FAS 131, at 4. When Petitioner in its annual and interim public financial statements issued to shareholders reported its investment in Lexis/Nexis as a "reportable business segment," that reporting was accomplished as a quantitative matter in accordance with FAS 14 and later FAS 131 to help users of Petitioner's financial statements. For example, the Association for Investment Management and Research commented during the preparation of FAS 131 that business segment data "is vital, essential, fundamental, indispensable, and integral to the investment analysis process." FAS 131, App. A, ¶ 44.

As a result, Petitioner's segment reporting did not evidence any use of or operational relationship for the Lexis/Nexis assets and Petitioner's business activities in Illinois or elsewhere. Indeed, if it did, then every "public business enterprise" that disposes of a reportable business segment recognizes apportionable income regardless of whether the underlying relationships satisfy this Court's constitutional requirements. Such a standard effectively defeats the purposes of the unitary business principle as a limitation on the taxing authority of a State in favor of a financial standard promulgated by FASB. Rather, the fact that Lexis/Nexis was required to be reported as a separate segment emphasizes the differences between Lexis/Nexis and the remainder of Petitioner's business activities. While Petitioner clearly cared about allocating resources and assessing the performance of

Lexis/Nexis, "that state of mind sheds little light on the question whether in pursuing maximum profits they treated [Lexis/Nexis] as serving, on the one hand, an investment function, or, on the other, an operational function." *Allied-Signal,* 504 U.S. at 784-785. *See also F.W. Woolworth*, 458 U.S. at 369 (the fact that taxpayer's published financial statements were prepared on a consolidated basis did not make the taxpayer and its foreign subsidiaries unitary).

Petitioner's segment reporting served public financial reporting requirements and represented a management oversight function for Petitioner that was required by FASB.

II. A DIFFERENT LINE OF BUSINESS THAT IS NOT IN A UNITARY RELATIONSHIP WITH ANOTHER LINE OF BUSINESS CONDUCTED IN THE TAXING STATE CANNOT SERVE AN OPERATIONAL FUNCTION FOR THAT LINE OF BUSINESS.

In the task of determining whether a unitary business relationship exists, or whether an investment serves an operational or investment function, differences in lines of business are significant. *See Container*, 463 U.S. at 178 ("Investment in a business enterprise truly 'distinct' from a corporation's main line of business often serves the primary function of diversifying the corporate portfolio and reducing the risks inherent in being tied to one industry's business cycle.") Petitioner's "main line of business" was paper,

packaging, and office and school supplies, whereas Lexis/Nexis provided online information services for legal, news and financial information in the electronic publishing market. J.A. 9, 10. In fact, Petitioner's business segment reporting highlights the diversity in the lines of business. Lexis/Nexis provided diversification from Petitioner's paper, packaging, office and school supplies business activities. Although Petitioner's cash management system performed the nightly cash "sweep" of Lexis/Nexis' bank accounts (and arguably benefited Lexis/Nexis by investing the funds for Lexis/Nexis' benefit), "it is also true that they are 'discrete business [enterprises]' that – in 'any business or economic sense' – have 'nothing to do with the activities' of" Petitioner in Illinois. *ASARCO*, 458 U.S. at 328 (citing *Mobil Oil*, 445 U.S. at 439-442). Petitioner's nightly cash "sweep" of Lexis/Nexis bank accounts represented nothing more than a "mere flow of funds arising out of a . . . distinct business operation." *Container*, 463 U.S. at 166.

It is difficult to fathom how assets that are used in one line of business can serve an operational function for the activities of another line of business that is diverse (and not unitary) with the former. For example, in *Container* the parent corporation's intercompany loans and loan guarantees served an operational function, because the parent and its foreign subsidiaries were engaged in vertically integrated business activities in the same line of business. *Container*, 463 U.S. at 178, 180 n. 19. Thus, any growth of overseas business activities in *Container* served operational

functions of the same or similar business activities in California (and the United States).

The Illinois Circuit Court found that Petitioner and Lexis/Nexis were not engaged in a unitary business relationship. Pet. App. 39a. This ruling was not disturbed or addressed by the Illinois Appellate Court on appeal. Pet. App. 11a. Thus, in the absence of a direct unitary relationship between diverse lines of business, the assets of Lexis/Nexis should not be viewed as an operational function of Petitioner's paper, packaging, office and school supplies business activities conducted in Illinois and other States.

CONCLUSION

For the foregoing reasons, *amicus curiae* Gannett Co., Inc. respectfully requests this Court to reverse the decision of the Illinois Appellate Court below.

Respectfully submitted,

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Dated: November 9, 2007

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No. 06-1413

IN THE

Supreme Court of the United States

THE MEADWESTVACO CORPORATION,
SUCCESSOR IN INTEREST TO THE
MEAD CORPORATION,
Petitioner,

v.

ILLINOIS DEPARTMENT OF REVENUE,
DIRECTOR OF THE ILLINOIS DEPARTMENT
OF REVENUE, AND TREASURER OF
THE STATE OF ILLINOIS,
Respondents.

On Writ of Certiorari
to the Appellate Court of the State of Illinois

BRIEF OF MULTISTATE TAX COMMISSION AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS

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BRIEF OF MULTISTATE TAX COMMISSION as *AMICUS CURIAE* IN SUPPORT OF RESPONDENTS[1]

INTEREST OF *AMICUS CURIAE*

Amicus Curiae Multistate Tax Commission ("the Commission") files this brief in support of Respondents, the Illinois Department of Revenue, the Director of the Department of Revenue and the Treasurer of the State of Illinois ("the State"). The Commission believes the decision below must be affirmed because the Petitioner, MeadWestvaco, Inc. ("the Taxpayer"), has failed to meet its "distinct burden of showing by 'clear and cogent evidence'", *Exxon Corporation v. Wisconsin,* 447 U.S. 207, 221 (1980), that the State imposed a tax on income earned outside of its borders when it apportioned income from the sale of its business segment which operated within the State. Because there is far more than the requisite "minimal connection" or "rational relationship", *Mobil Oil v. Commissioner of Taxes (Vermont),* 445 U.S. 425, 426-7 (1980), between the interstate activities conducted by the Taxpayer's unitary business in Illinois and the gain resulting from the sale of the assets used in that unitary

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[1] No counsel for any party authored this brief in whole or in part. Only *amicus* Multistate Tax Commission and its member states through the payment of their membership fees made any monetary contribution to the preparation or submission of this brief. This brief is filed by the Commission, not on behalf of any particular member State. Finally, this brief is filed with the consent of the parties.

business, the assessment of tax at issue in this matter should be sustained.

The Commission is the administrative agency charged with implementing and furthering the goals of the Multistate Tax Compact ("Compact"), which became effective in 1967. *See* RIA ALL STATES TAX GUIDE ¶ 701 *et seq.*, (2005). Today, forty-seven states and the District of Columbia are members of the Commission. Twenty have legislatively established full membership. Seven are sovereignty members and twenty-one are associate members.[2] This Court upheld the validity of the Compact in *United States Steel Corp.* v. *Multistate Tax Commission*, 434 U.S. 452 (1978).

The purposes of the Compact are to: (1) facilitate proper determination of State and local tax liability of multistate taxpayers, including equitable apportionment of tax bases and settlement of apportionment disputes, (2) promote uniformity or compatibility in significant components of tax systems, (3) facilitate taxpayer convenience and compliance in

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[2] Compact Members: Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Michigan, Minnesota, Missouri, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah and Washington. Sovereignty Members: Georgia, Kentucky, Louisiana, Maryland, New Jersey, West Virginia and Wyoming. Associate Members: Arizona, Connecticut, Florida, Illinois, Iowa, Indiana, Maine, Massachusetts, Mississippi, Nebraska, New Hampshire, New York, North Carolina, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Vermont and Wisconsin.

the filing of tax returns and in other phases of tax administration, and (4) avoid duplicative taxation.

These purposes are central to the very existence of the Compact, which was the States' answer to an urgent need for reform in State taxation of interstate commerce. *See e.g.*, H.R. Rep. No. 952, 89th Cong. 1st Sess., Pt. VI, at 1143 (1965).[3] The promise of increased uniformity established by the States' adoption of the Compact was critical to preserving the recognized sovereignty the States enjoyed, and continue to enjoy, with respect to taxation of interstate commerce. Preserving state tax sovereignty under our vibrant federalism remains a key purpose of the Commission.

The Commission attaches great importance to the present case precisely because the Taxpayer's arguments, if accepted, would greatly undermine this goal of preserving the States' authority to determine their own tax policies within federal constitutional and statutory limitations. In particular, the Commission is vitally concerned with the preservation of the States' constitutionally permitted use of formulary apportionment methods to fairly measure in-

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[3] The Willis Committee Report, a congressional study of state taxation mandated by TITLE II OF PUB. L. NO. 86-272, 73 STAT. 555, 556 (1959), made extensive recommendations as to how Congress could regulate state taxation of interstate and foreign commerce. *See generally Interstate Taxation Act: Hearings on H.R. 11798 and Companion Bills Before Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary*, 89th Cong., 2d Sess. (1966).

come generated from economic activity taking place within their borders. The capital gain at issue in this case was realized upon the sale of assets that performed an integral operational function in the Taxpayer's unitary electronic publishing business ("Lexis/Nexis"), a business division that operated continually in Illinois at least since the mid-1980's. Record Vol. 1, C244. The Taxpayer does not dispute Illinois' right to tax income generated from Lexis/Nexis (*Plaintiff's Post-Trial Reply Brief*, Record Vol. 8, C1881-2), but contends that Illinois cannot tax the gain resulting from the sale of the assets of that business segment because the sale itself was "an out-of-state event" (Brief of Petitioner ["Pet. Br."], p. 29) by a separate line of business ("Mead Paper") that also operated within Illinois. Under this Court's precedents upholding the principles of source-based taxation, the States have the ability to tax a fairly apportioned share of the gain from the sale of assets located within their borders, even though the sale is consummated out-of-state and even though the gain on the sale is realized by a Taxpayer who is also engaged in a second and arguably unrelated line of business in the State.

Because of this direct and undeniable operational connection between the assets from which the capital gain arose and the unitary business (Lexis/Nexis) with activities in the taxing State, the contours of the operational test for apportionment of income established by this Court in *Allied-Signal v. Director, Division of Taxation*, 504 U.S. 768 (1992) have been fully met. Even though, in this case, the capital gain income was included in the combined

apportioned income of the Taxpayer's two business segments, there is no claim that Illinois' apportionment method actually resulted in taxation of extraterritorial values. No such claim could be made because the gain arose from the activities of Lexis/Nexis, a business segment which operated continuously in Illinois, and in addition, the two lines of business had nearly identical apportionment factors within the State. The Commission accordingly believes it is unnecessary, in this controversy, to determine whether the gain could also have been subject to apportionment under the principles announced in *Allied-Signal, supra,* based on the assets' operational relationships with Mead Paper.

Where the capital gain at issue in this case was generated by a business conducting operations partially within the taxing State, and where there is no claim that the State's taxation of that gain has reached income generated beyond its borders, the sole remaining question is whether Illinois' tax constitutes a permissible burden on interstate commerce under the standards announced by this Court in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). The Commission believes Illinois' tax easily meets all four prongs of the *Complete Auto* test: (a) it is a tax upon activity with a substantial nexus to the taxing State; (b) it is fairly apportioned; (c) the tax is non-discriminatory; and (d) the tax is fairly related to benefits and protections afforded by the State. 430 U.S. at 279-80.

The Court should use the opportunities afforded by this case to reinforce its long-standing

commitment to the States' power to tax based upon the substance of how and where income is earned, as measured by formulary apportionment. The Commission thus urges this Court to reject the Taxpayer's invitation to abandon those precedents in favor of a return to the formalisms which characterized Commerce Clause and Due Process adjudication in the early part of the previous century.

SUMMARY OF ARGUMENT

The State of Illinois properly taxed an apportioned share of the capital gain recognized on the sale of the assets used in the Taxpayer's electronic publishing division (Lexis/Nexis), a unitary business which operated partially within Illinois. The assets which were sold—Lexis/Nexis' tangible property and the goodwill of the business—performed an integral operational function for that unitary business. Together, these factors establish Illinois' right to tax that share of the capital gain which can reasonably be attributed to values generated within the State. Properly apportioning the gain in accordance with Lexis/Nexis' factors results in approximately 4% of the gain being attributed to Illinois.

Even if Lexis/Nexis did not have such a direct presence within the State, Illinois would have the ability to include the capital gain in the Taxpayer's apportionable income tax base in two circumstances. First, the scope of the Taxpayer's unitary business with which the Lexis/Nexis assets were operationally connected could be defined to encompass both the

Taxpayer's paper manufacturing, sales and office supply business segment (Mead Paper), which also had activities in the State, and Lexis/Nexis. In that case, the gain would be properly apportioned with the income and factors of the two business segments combined; that calculation would apportion approximately 4% of the gain to Illinois.

Alternatively, even if the two business segments were not fully unitary, an operational connection between the Lexis/Nexis assets and the Mead Paper business segment alone would justify apportionment of income received from the sale of the Lexis/Nexis assets, using the income and factors of the Mead Paper business segment for purposes of apportionment. That calculation would also apportion approximately 4% of the gain to Illinois.

No matter how the scope of the unitary business is defined, it yields a business which operated in Illinois. While these different approaches to defining the unitary business could lead to different reporting consequences for state law purposes, the State's ability to tax a fairly-apportioned share of the gain does not change. No matter how the unitary business is defined in this case, a portion of its activity which generated the gain was carried on in Illinois. Where the tax liabilities under each methodology are nearly indistinguishable, foreclosing any claim of extra-territorial taxation, the determination of whether the gain should have been apportioned separately or in combination is essentially an academic exercise.

The Illinois Court of Appeals found that Lexis/Nexis' assets served an operational function for the Taxpayer within the State, including its Mead Paper business segment. While this Court need not reach the merits of that determination in order to uphold the assessment of tax in this case, the precedents of this Court firmly hold that such judgments are entitled to deference unless clearly unreasonable. Substantial evidence supports the lower court's determination that the Lexis/Nexis assets served an operational function for the Mead Paper business and that Lexis/Nexis was not merely a passive investment activity. The lower court's judgment should not be reversed absent overwhelming evidence to support a contrary conclusion.

The Taxpayer and its *amici* have also presented numerous policy arguments to support their position, most notably the potential for duplicative taxation, because, if their view of the facts and law were accepted, the Taxpayer's state of commercial domicile would have a right to tax such income under state law. (There is no claim in the case that the Taxpayer actually allocated this gain to Ohio, its commercial domicile, or that Ohio law would actually favor such allocation.) This Court's precedents clearly establish a preference for apportionment, rather than allocation, of unitary business income. And, properly sourcing this gain as apportionable unitary business income based upon Lexis/Nexis' presence in the taxing State, as Illinois has done, eliminates the potential for duplicative taxation.

ARGUMENT

ILLINOIS PROPERLY TAXED AN APPORTIONED SHARE OF THE CAPITAL GAIN ARISING FROM THE SALE OF ASSETS LOCATED WITHIN THAT STATE

The sole question before this Court is whether the State of Illinois offended either the Due Process Clause (Amend. XIV) or the Commerce Clause (Art. I, § 8) of the U.S. Constitution when it taxed an apportioned share of a capital gain realized from the sale of the assets of a business segment which operated within Illinois.

A State tax runs afoul of these constitutional restrictions only if it reaches income which clearly has its source beyond the State's borders. *Allied-Signal, Inc. v. Director, Division of Taxation,* 504 U.S. 768, 778 (1992). In previous decisions of this Court, that requirement has been variously described as necessitating "a minimal connection, or nexus between the [Taxpayer's] interstate activities and the taxing State", *Exxon Corporation v. Wisconsin Department of Revenue,* 447 U.S. 209, 219-220 (1980), and "a rational relationship between the income attributable to the taxing State and the intra-State values of the enterprise." *Mobil Oil Corporation v. Commissioner of Taxes of Vermont,* 445 U.S. 425, 436-7 (1980). The taxpayer asserting the invalidity of a tax "has the distinct burden of showing, by 'clear and cogent evidence' that [the State tax] results in extra-territorial values being

taxed..." *Butler Brothers v. McColgan,* 315 U.S. 501, 507 (1942).

The record in this case reveals very clearly that Illinois has not taxed income earned beyond its borders by taxing an apportioned share of the income realized from the sale of the assets of a unitary business which operated within the State.

A. The Assets Giving Rise To This Capital Gain Were Functionally Connected To The Taxpayer's Unitary Business Conducted in Illinois; The Assets Were Not Held As Passive Investments.

In the present case, the Taxpayer's Lexis/Nexis segment carried on substantial business within Illinois for years, operating sometimes as a division, and sometimes as a separately-incorporated subsidiary. J.A. 14.[4] In 1993, for instance, Lexis/Nexis had $4,406,947 in tangible property located within the State, $40,757,730 in sales, and paid its employees in Illinois $4,095,601 in wages. J.A. 189. While the Taxpayer conceded in the case below (Record Vol. 8, C1881-2) that Illinois would have the right to tax the income earned by Lexis/Nexis, it now contends that a different rule ap-

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[4] The decision to operate as a division or subsidiary was dictated in each instance by the Taxpayer's desire to lower its overall state tax liability. J.A. 14. Thus, in 1993 the Taxpayer decided to merge the corporations under which Lexis/Nexis conducted business back into Mead Paper so that Mead Paper could fully utilize net operating losses. Record Vol. 9, C1872; J.A. 134; 147.

plies to the taxation of the capital gain arising from the sale of that portion of the income-producing assets located in Illinois.

Nowhere in the Petitioner's Brief is there any attempt to identify where this gain arose from an economic standpoint, nor is there any attempt to explain why the State should not be able to tax a gain recognized on the sale of assets located within its borders. (In fact, the Taxpayer never mentions that Lexis/Nexis had a presence in Illinois at the time of the sale, nor that it did business in Illinois for at least nine years prior to that sale.)

Although the Taxpayer acknowledges that the prohibition of extra-territorial taxation lies at the heart of this Court's precedents applying the unitary business principle (Pet. Br. 20-24), it never applies that analysis to the facts of this case. In particular, the Taxpayer provides no authority for its oblique suggestions (Pet. Br. 21, 29) that the only taxable economic activity associated with a $1.05 billion gain was the sales transaction itself, and indeed it does not even identify where that transaction took place.

Because the Taxpayer omits any mention of Lexis/Nexis' Illinois presence, its brief provides no explanation for how the 1993 merger of Lexis/Nexis back into the Mead Corporation stripped Illinois of the ability under the Due Process Clause or Commerce Clause to tax the capital gain arising from the sale of these assets. One assumes that the Taxpayer would not contest Illinois' right to tax Lexis/Nexis on an apportioned basis had it sold some

of its assets while conducting business in Illinois as a separate entity. Once Lexis/Nexis was merged back into the Mead Corporation, Mead Corporation became the only entity which Illinois could have subjected to taxation unless the State chose to completely de-conform from federal tax standards.

The gravamen of Taxpayer's argument appears to be that the 1993 merger converted Lexis/Nexis' apportionable income into Mead Corporation's passive investment income. As investment income, the Taxpayer contends, the gain may only be taxed as a *constitutional* matter in the state of its commercial domicile, Ohio. Pet. Br. 50-53. The argument that the form in which income is recognized precludes its taxability was foreclosed in *Mobil Oil,* 445 U.S. 425 (1980):

> It remains to be considered whether the form in which the income was received serves to drive a wedge between Mobil's foreign enterprise and its activities in Vermont... Mobil has attempted to characterize its ownership and management of subsidiaries and affiliates as a business distinct from its sale of petroleum products in this country. ...
>
> At the outset, we reject the suggestion that anything is to be gained from characterizing the receipt of dividends as a separate taxable event. In *Wisconsin v. J.C. Penney Co., supra,* the Court observed that 'tags' of this kind 'are not instruments of adjudication but statements of result,'

> and they add little to the analysis. 311 U.S., at 444. Mobil's business entails numerous 'taxable events' that occur outside Vermont. That fact alone does not prevent the State from including income earned from those events in the pre-apportionment tax base.
>
> Nor do we find particularly persuasive Mobil's attempt to identify a separate business in its holding company functions. ....One must look principally at the underlying activity, not the form of investment, to determine the propriety of apportionability.

445 U.S. at 440. *Accord, ASARCO, Inc. v. Idaho State Tax Commission,* 458 U.S. 307, 330 (1982). The fact that Lexis/Nexis became one of two divisions of a single corporation a few months before its assets were sold presents no constitutional issues with respect to Illinois' right to tax a portion of that income based upon its source. By the same token, the fact that the capital gain could have been subject to apportionment as the "unitary" income of one of two separate business segments presents challenges of tax administration for Illinois, but does not add a constitutional dimension in this case, since under each scenario approximately the same percentage of the business' activity was conducted in Illinois and thus yields the same apportioned tax liability.

There is no dispute in this case that Lexis/Nexis was itself a unitary business operating in Illinois, and the assets which were sold (the tangi-

ble and intangible property of the entire business) were "operationally connected" to that business. Thus, the gain had a sufficient "nexus" to Illinois to allow apportionment by that State under *Allied-Signal*. As set forth below, these assets may alternatively have had an operational connection to Mead Paper, or to both Mead Paper and Lexis/Nexis if the scope of the unitary business operating in Illinois includes both business segments. See *Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 167 (1983)(noting that many variations of the unitary business concept "...are logically consistent with the motivations underlying the approach."). In this case, the different possibilities for defining the scope of the unitary business do not affect the ability of the State to impose an apportioned tax on the gain, nor do they result in different apportionment percentages. In this case, the different possibilities for defining the scope of the unitary business result in nearly identical tax outcomes.

1. The Scope of the Taxpayer's Unitary Business Conducted in Illinois Encompasses Lexis/Nexis, And Could Also Include Mead Paper.

The Lexis/Nexis assets were operational with a unitary business conducted by the Taxpayer in Illinois. Three possibilities exist for identifying and defining the scope of that unitary business: (a) the Taxpayer's paper and office supply business segment (Mead Paper) and the Taxpayer's electronic publishing segment (Lexis/Nexis) as constituting a single unitary business; (b) an operational connection

between Mead Paper and Lexis/Nexis; and (c) the Lexis/Nexis division and Mead Paper as completely independent. The different possibilities for analyzing the scope of the unitary business do not affect the ability of the State to impose its tax in this case, or the measure of that tax, for in all three instances Illinois' ability to tax the income is coextensive with the amount of income generated within the State.

a. Lexis/Nexis and Mead Paper as a Single Unitary Business. The Taxpayer filed all of its State corporate income tax returns in Illinois from 1988 through 1994, the year the gain was recognized, as if Mead Paper and Lexis/Nexis were fully unitary. Although the Taxpayer now claims the two business segments were non-unitary,[5] it made no effort to separately report the income and expenses of its two business segments and subject that income to separate apportionment calculations. See, e.g., Record Vol. 9, *Report of Proceedings*, C240-241; *Cf., Amerada Hess, Inc. v. Director, Division of Taxation*, 490 U.S. 66 (1989)(windfall profits tax on oil production were expenses of the Taxpayer's unitary energy

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[5]The Petitioner's Brief states that the Taxpayer "had filed, under protest, a tax return as a unitary business at the directive of the Illinois Department of Revenue." Pet. Br. 12. The record reflects that the Taxpayer agreed, as part of an audit settlement, not to contest the Department's decision to treat the two businesses as unitary for the 1984-1985 tax years. Record Vol. 1, C244. Nothing in the record supports the contention that the Taxpayer's decision to continue filing that way for the next eight years was compelled by the State; in fact, Lexis/Nexis was merged back into the Taxpayer in order to secure state tax advantages which would only accrue to a unitary combined filer. J.A. 147.

business and could not be separately sourced to locations where oil was extracted).

b. Lexis/Nexis and Mead Paper as Operationally Connected Business Segments. The facts in this case could also support a finding that Mead Paper and Lexis/Nexis were not a single unitary business, but the assets of Lexis/Nexis were operationally or functionally connected to one or the others' separate unitary businesses in Illinois.

In *Allied-Signal,* 504 U.S. at 787, this Court explained the concept as follows:

> We agree that the payee and payor need not be engaged in the same unitary business as a prerequisite to apportionment in all cases. *Container Corp.* [*of America v. Franchise Tax Board,* 463 U.S. 159 (1983)] said as much. What is required is that the capital transaction serve an operational rather than an investment function.

Under this analysis, the apportionable income of the Taxpayer would include the income derived from the operationally-connected source.[6] The opera-

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[6] Receipt of income from an operationally-connected source would generally not justify inclusion of the factors of the payor in the apportionment formula. (For instance, in the case of interest received from investment of short-term capital, the apportionment formula would not include a percentage of the payor's factors.) In the present case, the Taxpayer combined the factors of Lexis/Nexis with Mead Paper's factors, and the State did not contest that treatment. Record Vol. 4, C850. The

tional connection between income source and income recipient is the justification for apportionment upheld by the Illinois Court of Appeals in the case below. Pet. App. 18a. As set forth in the Respondent's Brief, the evidence of interdependence between the two segments is substantial. Rep. Br. 1-8; 25-29.[7]

c. Lexis/Nexis and Mead Paper as Distinct Business Segments. The third possibility is that the two business segments were not unitary and the assets of the Lexis/Nexis segment were not operationally or functionally connected at all. In such a situation, the unitary business income of the two business segments should be separately apportioned according to their separate factors on a *pro-forma* return.

2. Apportioning the Gain to a Single Unitary Business or to One of Two Separate Unitary Businesses Does Not Affect the Amount of the Gain Subject to Illinois' Tax in this Case.

Correctly defining the parameters of the unitary business(es) doing business in the State is a critical step for ensuring that the State's tax bears "a rational relationship...to the intrastate values of the

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State did adjust the sales factor of the apportionment formula by including the gain in the denominator and increasing the numerator by approximately $40 million to reflect that portion of the gain attributable to Lexis/Nexis' intangible property located within the state. J.A. 184-188.

[7] In fact, the Taxpayer suggested in its answers to interrogatories that it was impossible to separate the income and expenses of the two business segments for years in which they were merged into a single entity. Record Vol. 1, C245, 248-249.

enterprise." *Mobil Oil*, 445 U.S. at 436-7 (1980). Where the unitary business could reasonably be defined to encompass either a single business segment or multiple segments, different tax consequences may arise from the fact that each business segment will likely have different in-state apportionment percentages. In the present case, however, the outcomes are not significantly different because the Illinois apportionment percentages for the Taxpayer and Lexis/Nexis are almost identical. Using Illinois' four-factor formula, which double-counts the sales factor, Lexis/Nexis' apportionment percentage in Illinois for 1993[8] was 4.7056%, slightly higher than the Taxpayer's average apportionment percentage of 4.1134%. Record Vol. 1, 154; J.A. 189.[9] Because Lexis/Nexis' Illinois' apportionment percentage was a fraction of a percentage higher than Mead Corpora-

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[8] Lexis/Nexis' 1993 factors were used by the State's auditor to adjust the sales factor to apportion some of the capital gain to Illinois because those were the latest numbers available. Record Vol. 9, *Report of Proceedings*, C234.

[9] The Illinois apportionment percentages for the two business segments would not change materially if an equally-weighted three-factor apportionment formula was employed instead of the four-factor formula. See *Container Corporation*, 463 U.S. at 170 (describing the three-factor formula as "something of a benchmark against which other apportionment formulas are judged."). The factors of Mead Corporation (including Lexis/Nexis) and Lexis/Nexis separately were:

Mead Corp. Factors (1994):	Lexis/Nexis Factors (1993):
Property: 2.002%	Property: 1.4166%
Payroll: 2.9664%	Payroll: 2.1629%
Sales: 5.7426%	Sales : 7.6215%
Total: 10.711%	Total: - 11.201%
Average:3.5703%	Average: 3.7336%

tion's, the Taxpayer would have had a higher overall tax liability had Illinois treated the Lexis/Nexis business segment as a separate line of business from Mead Paper.

B. The Value Being Taxed In This Case Is The Appreciation of Lexis/Nexis' Assets, Particularly Its Goodwill; Those Assets Were Partially Located In Illinois.

It is axiomatic that in order for a State to have jurisdiction to impose a tax there must be "some definite link, some minimum connection, between the State and the person, property or transaction it seeks to tax." *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344-5 (1954); *Exxon v. Wisconsin*, 447 U.S. at 229. *J.C. Penney Corp. v. Wisconsin, 311 U.S. 435 (1940); International Harvester v. Wisconsin*, 322 U.S. 435, 446 (1944).

Whether a portion of this capital gain can be taxed by Illinois thus turns on whether the interstate activities sought to be taxed (the realization of a gain on a business which had been developed and nurtured in multiple States, including Illinois) bears some rational relationship or minimal connection to the taxing State. *Mobil Oil*, 445 U.S. at 436-7. It was the Taxpayer's burden in this case to demonstrate that there was no such rational relationship between the apportioned tax imposed by Illinois on the gain and the "opportunities...protection[s]...and benefits" afforded by the State. *Wisconsin v. J.C. Penney Co.*, 311 U.S. at 444. The Taxpayer did not meet this burden. Indeed, by ignoring Lexis/Nexis'

presence in the State it has all but abandoned the point before this Court.[10]

In this case, the capital gain of $1.05 billion arose from the sale of the Taxpayer's unitary electronic publishing division, Lexis/Nexis, including tangible and intangible property.[11] The intangible property at issue here was the business goodwill of Lexis/Nexis, that is, the value of the business as a going concern over and above the book value of its tangible property. *See, e.g., Newark Morning Ledger v. United States*, 507 U.S. 546, 555 (1993); *United States v. Winstar Corp.*, 518 U.S. 839 (1996). In the case of Lexis/Nexis, goodwill represented the willingness of customers to continue to subscribe to Lexis/Nexis databases, and the willingness of its employees to continue to apply their skills and experience. Lexis/Nexis had fifty sales offices throughout the world charged with generating and maintaining

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[10] The Taxpayer did claim in the proceedings below that apportionment of the gain would result in an overstatement of its earnings in the State, based on a separate accounting analysis. Record Vol. 1, C92; Vol. 8, C1922. The trial court rejected the distortion claim. Record, Vol. 8, C1925-6. The Taxpayer now argues only that Illinois' taxation of the gain would result in a "misattribution of taxable income" between domiciliary and non-domiciliary states (Pet. Br. 49), but does not demonstrate how the gain arose from economic activity occurring in Ohio, the Taxpayer's domicile. The Taxpayer's current argument appears to be limited to the claim that domiciliary states might also seek to tax such income as a matter of state law. Pet. Br. 48-53.

[11] Although the Taxpayer's brief focuses on the tax treatment of the intangible property, it is not clear whether the Taxpayer concedes that a portion of the gain attributable to Lexis/Nexis' tangible property ($126,455,018 (J.A. 189)) should have been allocated to Illinois. *Compare*, Record Vol. 1, C93 and Record Vol. 9, *Report of Proceedings* 227-228.

goodwill,[12] and 2.1% of its employees were located in Illinois, where it had an operational headquarters for one of its divisions. J.A. 14; 99; 104; 189. Lexis/Nexis had contracts with Illinois customers which generated $40.7 million in annual receipts. J.A. 189. As in the case of trademarks, which represent goodwill, the value of goodwill cannot be separated from the business itself as an economic matter. Cf., *Visa, U.S.A., Inc. v. Birmingham Trust National Bank*, 696 F.2d 1371 (C.A. Fed. 1982), *cert. den.*, 464 U.S. 826 (1983).

The Taxpayer's intangible property thus had a taxable business situs in Illinois, and as such, income from its disposition was properly subject to Illinois' taxing power, as a long line of this Court's precedents have held. In the seminal case of *Adams Express Co. v. Ohio*, 165 U.S. 194, 223-224 (1897) this Court directly confronted the question of where a unitary business' intangible property is "located" for purposes of apportioning value for property tax purposes:

> [i]s it simply where the home office is, where is found the central directing thought which controls the workings of the great machine, or in the State which gave

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[12] For instance, in its 1993 Annual Report, the Taxpayer announced: "Sales from the business information services area led the way for [Lexis/Nexis] as it aggressively targeted new business while strengthening relationships with existing customers." J.A. 81.

> it its corporate franchise, or is that intangible property distributed wherever its tangible property is located and its work is done? Clearly, we think the latter.

The rule announced in *Adams Express* for assigning intangible property values to where the enterprise conducts its operations has been followed in the context of income taxes, both as a federal constitutional matter and as a matter of state law. Thus, in *Whitney v. Graves*, 299 U.S. 366 (1937), this Court held that New York could impose an income tax on an out-of-state resident on the capital gain received from the sale of a membership on the New York stock exchange. This Court wrote in that case:

> When we speak of a 'business situs' of intangible property in the taxing State we are indulging in a metaphor. We express the idea of localization by virtue of the attributes of the intangible right in relation to the conduct of affairs at a particular place.

299 U.S. at 372. See also, *Wheeling Steel Corporation v. Fox*, 298 U.S. 193 (1936)(intangible property acquires a taxable business situs where employed); *Curry v. McCanless*, 307 U.S. 357, 367 (1939)(same). The "intangible" at issue in this case is the value of the on-going business conducted in multiple States, including Illinois; the value of that property cannot be localized in the Taxpayer's commercial domicile. Accord, *A&F Trademarks, Inc. v. Tolson*, 605 S.E.2d 187 (N.C. App. 2004); *Kmart*

Properties, Inc. v. Taxation and Revenue Dep't., 139 N.M. 177, 131 P.3d 27 (N.M. Ct. App. 2001), *writ quashed, rev'd in part*, 131 P.3d 22 (N.M. 2005).

1. Illinois' Tax Can Be Sustained Even in the Absence of a Unitary or Operational Connection to Mead Paper's Business Activity in Illinois Where There is a Unitary or Operational Connection to Lexis/Nexis' Business Activities Within the State.

That the State has a right to impose its income tax based on the in-state source of that income should be beyond dispute. *Allied-Signal*, 504 U.S. at 778; *Exxon Corporation v. Wisconsin*, 447 U.S. at 229; *International Harvester Company v. Wisconsin Department of Revenue*, 322 U.S. 435 (1944); *Whitney v. Graves*, 299 U.S. 366 (1937); *Shaffer v. Carter*, 252 U.S. 37, 52 (1920); See also, Swain, *State Income Tax Jurisdiction: A Jurisprudential and Policy Perspective*, 45 William & Mary L. Rev. 319, 363 (2003)("the Court in *International Harvester* and *Whitney* strongly adhered to the principle of source taxation, and, more generally, to acknowledging the primacy of economic substance in income tax matters."); J. Hellerstein & W. Hellerstein, *State Taxation* ¶ 6.04, 6-13 (3rd ed., 2006). Nor is there any question in this case as to the State's jurisdiction over the Taxpayer (as opposed to the income), since the Taxpayer engaged in substantial business in the State and availed itself of the State's protections. See *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).

All of this Court's modern cases involving the application of the unitary business principle, including *F.W. Woolworth Co. v. New Mexico*, 458 U.S. 354 (1982), *ASARCO v. Idaho, and Container*, have done so in the context of income which arguably had its source outside of the taxing jurisdiction, for, as this Court has repeatedly held, the relevant question is whether the State has impermissibly taxed extraterritorial values by including that income in the apportioned base. Accord, *Bass, Ratcliff, & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271 (1924); *Butler Brothers v. McColgan*, 315 U.S. 501 (1942). Thus, in *ASARCO v. Idaho* the question was presented as:

> whether the State of Idaho constitutionally may include within the taxable income of a non-domiciliary parent corporation doing some business in Idaho a portion of intangible income—such as dividends and interest payments, as well as capital gains from the sale of stock that the parent corporation receives from subsidiary corporations *having no other connection* with the taxing State.

458 U.S. 307, 308-9 (emphasis added). In *F.W. Woolworth Co.*, 458 U.S. 354, 356 (1982), the opening question was framed as: "whether the Due Process Clause permits New Mexico to tax a portion of dividends that appellant F. W. Woolworth Co. received from foreign subsidiaries *that do no business in New Mexico.*" (emphasis added). This Court concluded that:

> New Mexico, in taxing a portion of dividends received from such enterprises, is attempting to reach "extraterritorial values," Mobil, supra, at 442, wholly unrelated to the business of the Woolworth stores in New Mexico. As a result, a "showing has been made that income unconnected with the unitary business has been used in the" levy of the New Mexico tax. *Butler Bros. v. McColgan*, 315 U.S. 501, 509 (1942). We conclude that this tax does not bear the necessary relationship "`to opportunities, benefits, or protection conferred or afforded by the taxing State. *See Wisconsin v. J. C. Penney Co.*, 311 U.S. 435, 444.

Id. at 372. In *Mobil Oil v. Vermont*, the dividend income in question was from "subsidiaries and affiliates doing business abroad." 445 U.S. at 427. In *Container*, the issue was whether apportionment of the income and factors of allegedly more-profitable foreign subsidiaries combined with domestic operations resulted in an overstatement of California income. 463 U.S. at 180-186. In *Exxon Corporation v. Wisconsin Department of Revenue*, 447 U.S. at 212, the question presented was whether Wisconsin could include in its apportioned tax base income derived from exploration, production and refining operations all of which took place outside the State.

And in *Allied-Signal*, the question presented was whether New Jersey could impose an appor-

tioned tax on investment income unconnected with the taxpayer's unitary business activity carried out in the State. [13]

In each of these cases, reference to unitary business principles was necessitated precisely because there was no other connection between the income and the taxing State; in the absence of such a connection, apportionment raised the potential for extra-territorial taxation. The on-going substantial presence of Lexis/Nexis within Illinois distinguishes this case from those cited above. Where such a direct connection exists between the income source and the State, reliance on any operational connections the income may have with other activities carried on by the Taxpayer in the State is unnecessary.

Because the imposition of tax in this case may be sustained independently of any unitary or func-

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[13] The Taxpayer may note that the investee corporation, ASARCO, was incorporated in New Jersey, although it appears its commercial domicile was elsewhere. Because New Jersey hoped to sustain its tax on a theory of full apportionment, it did not raise ASARCO's connection with the taxing state as an alternative basis to sustain the tax. See Hellerstein, *State Taxation of Income from Intangibles: Allied-Signal and Beyond*, 48 Tax L. Rev. 739, 787 (1994). This Court's analysis suggests that an independent connection to the investee's business activities could support taxation. When providing an example of how income received from a non-unitary source could still be apportioned if it had an operational connection to the taxpayer's unitary business conducted in the taxing state, this Court provided a hypothetical involving a short-term deposit of working capital in an unrelated *out-of-state* bank. 504 U.S. at 787.

tional connection between Lexis/Nexis and Mead Paper, the proper focus of this Court's inquiry should be whether Illinois' tax has impermissibly burdened interstate commerce. In *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), this Court established a four-part test for judging the validity of a State tax on activities in interstate commerce: (a) is the tax upon activity with a substantial nexus to the taxing State; (b) it is fairly apportioned; (c) is it non-discriminatory; and (d) is the tax fairly related to benefits and protections afforded by the State? 430 U.S. at 279-80.

Illinois' tax unequivocally meets all four prongs of the *Complete Auto* test. First, the incidence of the tax is the sale of assets located partially in Illinois. Second, the tax is fairly apportioned, since the percentage of the gain which was taxed is nearly identical to Lexis/Nexis' presence in the State. Third, the tax is non-discriminatory; if every State imposed its tax based on Lexis/Nexis' in-state presence, no double-taxation would occur. Finally, the tax is fairly related to the benefits and protections Illinois provided to the Taxpayer.

Although the Taxpayer has chosen to devote the entirety of its brief to addressing what it believes is a lack of operational connection between the two business segments, it should not come as a surprise to it that a second and independent basis to tax exists. This issue was raised in the circuit court proceedings below. See *State's Supplement to Defendant's Post-Trial Brief*, Record Vol. 8, C1887-8. The circuit court agreed with the State's argument,

making a mixed factual/legal conclusion in its *Memorandum Decision, Judgment and Order:*

> [t]he sale of Lexis/Nexis included assets which were situated in Illinois and used in the production of income reported to Illinois. That activity provides a nexus between Illinois and Lexis/Nexis which reaches the gain on the sale. Work papers provided by Mr. Murray and the report provided by Mr. Yano both show that there were assets, personnel and sales of Lexis/Nexis in Illinois for the 1994 year.

Record Vol. 8, C1929. Then as now, the Taxpayer can cite to no authority for its contention that a State loses its authority to tax a non-domiciliary's income generated within its borders when the income is recognized as a capital gain. Nothing in *Whitney v. Graves* suggests a basis for a constitutional distinction between taxing the owner of intangible property on income derived from property in the form of earnings and income derived in the form of a capital gain. As this Court held in *Complete Auto Transit*, the States' right of taxation under the Commerce Clause is not conditioned upon the label or classification which might be attached to that income. 430 U.S. at 288-9.

2. Because Illinois Has Provided Protections to Lexis/Nexis, the State Could Tax an Apportioned Share of the Gain in this Case Even if Mead Paper Merely Invested in Lexis/Nexis and Had No Other Connection to the Taxing State.

Finally, even if the Court accepted the Taxpayer's contention that it operated only a single business, Mead Paper, and chose to discount the Taxpayer's representations to the public, investors and tax authorities that it operated Lexis/Nexis as a business (J.A. 59; 92-93; 106-108; 120-21), Illinois could still assert jurisdiction over that income as a constitutional matter. This point was brought home in *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940) and *International Harvester v. Wisconsin, supra.* In both cases, this Court upheld Wisconsin's tax on dividends paid from non-domiciliary corporations doing business in the State where the incidence of the tax fell on shareholders. In both cases, this Court noted that the tax was justified by the protections and benefits provided to the investors' in-state property. See also, *Allied-Signal, Inc. v. Commissioner of Finance (New York),* 79 N.Y. 2d 73, 588 N.E. 2d 731 (N.Y. 1991); *Cf., Borden Chemicals & Plastics, LLP v. Zehnder*, 312 Ill. App. 3d. 35, 726 N.E. 2d. 73 (2000)(taxation of distributed share of income to non-resident partner of pass-through entity).

C. Any Danger Of Double Taxation Is Avoided By This Court's Default Rule Preferring Apportionment To Allocation Where Both The Domiciliary And The Source States May Tax The Income

The intangible assets of Lexis/Nexis were operationally connected to its business and thus the capital gain from their sale is unitary business income subject to apportionment under *Allied-Signal*. Under normative rules for state income taxation as embodied in the Uniform Division of Income for Tax Purposes Act ("UDITPA"), the gain from the sale of assets used in a unitary business is not classified separately from ordinary operating income for purposes of apportionment. UDITPA, Sections 1 & 9, *reprinted in*, J. Hellerstein & W. Hellerstein, *State Taxation*, Appendix A, pp. A1-A11. (3rd ed. 2006). There is no special rule for separately apportioning or allocating business income arising from intangible property, or business income designated as capital gains, although the sales factor is adjusted where possible to reflect the source of intangible income. *Id.*, Section 17; Multistate Tax Commission Model Regulation IV.18(c)(3), *reprinted in*, *State Taxation*, Appendix B, p. B-38. Thus, if all States in which Lexis/Nexis did business taxed an apportioned share of this gain based on that business' presence in the State, no duplicative taxation would occur.

Mead's contention that the gain on the sale of Lexis/Nexis assets should default to Ohio, Mead's domicile, goes against this Court's jurisprudence fa-

voring apportionment of unitary income, and could lead to double taxation.

This Court has made clear that, where multiple States have the power to tax unitary income on an apportioned basis, allocation of that income is disfavored. *Mobil Oil*, 445 U.S. at 444 (rejecting taxpayer's argument that income from intangibles should be allocated rather than apportioned so as to avoid double taxation). The possibility of double taxation caused by conflicting state tax sourcing rules is not enough to strike down a State's apportioned tax in the absence of demonstrated extraterritorial taxation. *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267 (1978). When the two approaches are equally constitutionally supportable, this court has favored apportionment, and not, as the taxpayer proposes, allocation. In *State Taxation*, ¶ 6.03, the authors note:

> Although the source principle is more circumscribed than the residence principle in a geographic sense, it is the dominant principle in cases of conflict between residence and source principles. In other words, when both the state of domicile and the state of source have a legitimate claim to tax income, the state of domicile ordinarily yields to the state of source to avoid double taxation. This is true both as a matter of national and international practice, and as a matter of federal constitutional law.

See also, W. Hellerstein, *State Taxation of Corporate Income from Intangibles, Allied-Signal and Beyond*, 48 Tax L. Rev. 739, 804-5 (1993), and cases cited therein.

Because Illinois clearly has the power to tax a properly-apportioned share of the gain on the sale of Lexis/Nexis, this Court's apportionment jurisprudence would disfavor the allocation of 100% of that gain to one State.[14] The rule urged by the Taxpayer in this case – that gain on the sale of the assets functionally connected to the operation of a unitary business in multiple states be allocated to the domiciliary state – would confuse the Court's current clear preference and open the door for potential double taxation.

In addition, as the facts of this case illustrate, abandonment of source-based principles for income taxation would encourage taxpayers to transfer the ownership of business assets to a separate subsidiary domiciled in a no-tax or low-tax jurisdiction prior to sale, thus converting apportionable unitary income into income that is allocable wherever a taxpayer would like to allocate it. The Taxpayer's default rule

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[14] It bears repeating that it is not at all clear that Ohio in fact allocated 100% of the gain on the sale of Lexis/Nexis to itself. Petitioner's Brief strongly suggests otherwise. Pet. Br. 53 n. 13. It is likely that Ohio, like Illinois, would treat the gain as apportionable business income. *See, e.g, Kempel v. Zaino*, 746 N.E. 2d 1073, 1075 (Ohio 2001).

is not tailored to avoid double taxation. It is tailored to encourage "nowhere" income.

Furthermore, this Court's default rule favoring source state apportionment as a matter of constitutional law is consistent with soundly reasoned state tax policy. In *State Taxation*, the authors note, in the context of describing the "functional test" for business income under UDITPA:

> [G]ain from the disposition of property used in the taxpayer's business represents recoupment of expenses deducted from apportionable income while the property was used in the business... . It would be incongruous (and, from the state's standpoint, inequitable) for a taxpayer to be able to reduce in-state apportionable income through ... deductions while the asset was being used in the ... business and then, when the asset is sold, to avoid "recapture" of that income in the state by treating the income from the sale as nonbusiness income allocable to another state.

State Taxation ¶9.05[2][c], at 9-44 – 9-45.[15]

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[15] Professor Hellerstein is of the view that state tax policy strongly supports a functional test but he could not find support for such a test in the statutory language. A number of courts have found otherwise. *See, for example, Hoechst Celanese Corporation v. Franchise Tax Board*, 25 Cal. 4th 508, 22 P. 3d 324, 106 Cal. Rptr. 2d 548, *cert. den.*, 534 U.S. 1040 (2001). In this case, the Taxpayer's claim that this gain gave rise to non-

This recognition of a capital gain as a recoupment of apportionable business expenses further demonstrates why there is no constitutional basis for a distinction between sourced-based taxation of capital gains and operating income. In fact, the record in this case provides a clear example of the connection between operating income and capital gains. The Taxpayer's 1993 Annual Report to Shareholders announced that:

> Mead Data Central [Lexis/Nexis] revenues grew 11% in 1993. However, strategic investments to enhance the features and functionality of its services, as well as expenditures for new product development and sales force restructuring, offset the effect of sales growth resulting in little earnings change from 1992.

J.A. 67. The improved business operations which resulted from those investments decreased current apportionable income but increased the business' value and the resulting goodwill of the business, leading to a higher capital gain when the business assets were sold in the following year. In essence, the reinvestment of the revenues into business operations amounted to a decision to defer profits and the taxes on them until the business was sold. The operational source of the profits did not

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business income under Illinois law has been rejected by the Illinois Court of Appeals. Pet. App. 18a.

change. The close interrelationship between current earnings and capital gains in this example confirms this Court's wisdom in predicating taxing authority on economic substance instead of accounting classifications.

The Court's existing default rule in favor of source-based taxation over domiciliary-based taxation is sound both as a matter of constitutional law and as a matter of state tax policy. Petitioner has adduced no sound reason to change that default rule and this Court should decline to do so.

CONCLUSION

For the reasons set forth above, *Amicus Curiae* Multistate Tax Commission urges this Court to affirm the decision of the Illinois Court of Appeals.

Respectfully submitted,

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No. 06-1413

IN THE

Supreme Court of the United States

MEADWESTVACO CORPORATION,
Successor in Interest to THE MEAD CORPORATION,
Petitioner,

v.

ILLINOIS DEPARTMENT OF REVENUE,
DIRECTOR OF THE ILLINOIS DEPARTMENT OF REVENUE,
AND TREASURER OF THE STATE OF ILLINOIS,
Respondent.

On Writ of Certiorari to the Illinois Appellate Court

BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* SUPPORTING REVERSAL

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UNIFORM LAWS

Uniform Division of Income for Tax Purposes Act 8

IN THE

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BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS *AMICUS CURIAE* SUPPORTING REVERSAL

INTEREST OF *AMICUS CURIAE*

Pursuant to Rule 37 of the Rules of this Court, Tax Executives Institute, Inc. respectfully submits this brief as *amicus curiae*.[1] Tax Executives Institute

[1] Pursuant to Rule 37.6, *amicus* Tax Executives Institute, Inc. states that no counsel for a party has written this brief in whole or in part and that no person or entity, other than *amicus*, its members, or its counsel, has made a monetary contribution to the preparation or submission of this brief. Both parties have consented to the filing of this *amicus* brief.

(hereinafter "TEI" or "the Institute") is a voluntary, non-profit association of corporate and other business executives, managers, and administrators who are responsible for the tax affairs of their employers. TEI was organized in 1944 under the laws of the State of New York and is exempt from taxation under section 501(c) (6) of the Internal Revenue Code of 1986 (26 U.S.C.). The Institute is dedicated to promoting the uniform and equitable enforcement of the tax laws, reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers, and vindicating the Commerce Clause and other constitutional rights of business taxpayers.

TEI has approximately 7,000 members who represent more than 3,000 of the leading corporations in the United States, Canada, Europe, and Asia. TEI's members represent a cross-section of the business community whose employers are, almost without exception, engaged in interstate commerce. Therefore, TEI's members have a keen interest in this case, which involves the constitutional limits on the States' ability to impose tax on a nondomiciliary taxpayer's income that bears no connection to the taxpayer's in-state activities.

The multijurisdictional companies represented by the Institute's membership are directly and materially affected by the rules governing allocation and apportionment of income among the various States. If the decision of the Appellate Court of Illinois is allowed to stand, then not only will Petitioner MeadWestvaco Corporation (hereinafter "Mead") be denied the protections of the Commerce and Due Process Clauses, but the vitality of the Court's holding in *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992), will be undermined and tax-

payers throughout the Nation will suffer from the resulting uncertainty, the increase in the cost and burden of compliance, and the enhanced potential for duplicative taxation. As the professionals who must contend daily with the interpretation and administration of the Nation's tax laws, the Institute's members have a vital interest in the proper disposition of this case.

SUMMARY OF ARGUMENT

The State of Illinois has erroneously sought to tax the gain realized by MeadWestvaco Corporation ("Mead") upon its disposition of Lexis/Nexis, a nonunitary, nondomiciliary company it held for investment. In sustaining the State's attempt to tax that gain, the Illinois Appellate Court vitiated the Court's holding in *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992), which held that a State may not tax the income of a nondomiciliary corporation if the income is derived from business activities that constitute a distinct business enterprise with business operations unrelated to the business carried on in the State.

Under the Commerce and Due Process Clauses of the Constitution, taxation by a State of the out-of-state income of a domiciliary corporation requires a connection between the interstate activities of the enterprise and the taxing State and a rational relationship between the income attributed to the State, from the interstate activity, and the intrastate values of the enterprise. *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 436-37 (1980). And, while this Court has permitted apportionment of income even in the absence of a unitary business relationship, it has done so only

when the asset in question serves an operational rather than an investment function. Here, Lexis/Nexis possessed neither the requisite link with Illinois nor did it serve an operational function to Mead's unitary business in the State of Illinois. Nevertheless, the Appellate Court in Illinois misapprehended this Court's teaching in *Allied-Signal*, holding the gain to be taxable in Illinois.

Lexis/Nexis and Mead were separate and distinct businesses, exhibiting neither functional integration, centralization of management, nor economies of scale—the three attributes that have been focus of the Court's unitary analysis. Moreover, their relationship possesses none of the external or internal indicia that are hallmarks of an operational relationship. These criteria transcend the sometimes artificial and formulary distinctions often associated with the form and degree of ownership and focus instead on the essence of the relationship and the linkage between the entities. That linkage must be substantial before the transaction or income becomes apportionable and subject to tax.

A decision upholding the court below would allow the States to impose tax on intangible income without real regard to the connection between the income and the taxpayer's activities in the State. Let stand, then, the Illinois decision would lead to multiple taxation of extraterritiorial income by permitting the apportionability of income based on the most attenuated of relationships. Such a result would eviscerate the Court's teaching in *Allied-Signal*.

ARGUMENT

I. THE IMPORTANCE OF THIS CASE: VIVIFYING THE COMMERCE AND DUE PROCESS CLAUSES

The Due Process and Commerce Clauses of the U.S. Constitution[2] require some definite link, or nexus, between a State and a taxpayer or activity to be taxed. Without such a connection, a State's taxing scheme will be struck down as unconstitutional. This case presents the question of what connection must exist between the State of Illinois and the income of a nondomiciliary taxpayer (Mead) from out-of-state sources or activities (specifically, the sale of another company, Lexis/Nexis) before that income can be apportioned to, and therefore taxed by, the State. In *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768 (1992), the Court held that when investment income is derived from activities unrelated to the in-state business activities of a unitary business, "due process considerations . . . preclude apportionability [and hence taxation." *Id.* at 780.[3] In sustaining Illinois's effort to tax Mead on the Lexis/Nexis gain, the court below vitiated the Court's holding in *Allied-Signal* and therefore denied Mead the protections accorded by the Commerce Clause.

Under the Commerce and Due Process Clauses of the U.S. Constitution, a State is prohibited from taxing value outside of its borders. Such taxation is

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[2] U.S. Const. art. I, § 8, cl. 3 (Commerce Clause); U.S. Const. amend. XIV, § 1 (Due Process Clause).

[3] "A State may not tax a nondomiciliary corporation's income . . . if it is derive[d] from 'unrelated business activity' which constitutes a 'discrete business enterprise.'" *Id.* at 773 (quoting *Mobil Oil v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980)).

proscribed because the "fundamental purpose of the [Commerce] Clause is to assure that there be free trade among the several States," *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318, 335 (1977), and because extraterritorial taxation offends fundamental notions of due process and constitutes an "unreasonable clog upon the mobility of commerce." *Baldwin v. G.A.F. Seelig, Inc.*, 294 U.S. 511, 527 (1935).

To tax the out-of-state income of a nondomiciliary corporation, there must be a "minimal connection between the interstate activities and the taxing State, and a rational relationship between the income attributed to the State and the intrastate values of the enterprise." *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 436-37 (1980) (quoting *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978)). A State may not tax the income of a nondomiciliary corporation—such as Mead here—if the income is derived from business activities that constitute a discrete business enterprise with business operations unrelated to the business carried on in the State. *See Allied-Signal*, 504 U.S. at 780. Indisputably, that is what Illinois is seeking to do here.

II. LEXIS/NEXIS WAS NOT UNITARY WITH MEAD

Petitioner MeadWestvaco Corporation is the successor-in-interest to Mead Corporation, an Ohio corporation, whose principal trade and business is producing and selling forest products, including paper, packaging and paperboard, and school and office supplies. Mead conducted its business in several states, including the State of Illinois. In 1968, Mead purchased Data Corporation, an Ohio-based company whose focus was developing inkjet

printing technologies. Data Corporation was also in the process of developing a computerized full text information retrieval system that, for the first time, used computer technology in legal research. After the purchase of Data Corporation, the computerized full-text information retrieval system became known as Lexis/Nexis.

After its acquisition of Data Corporation, Mead continued its business of manufacturing and selling paper and office products. Lexis/Nexis eventually became the world's premier provider of online legal information.

During the years it owned Lexis/Nexis, Mead treated the company as a business separate and distinct from its paper products business. The two did not share personnel or make joint purchases. They maintained separate headquarters, had no centralized operations, and were not functionally related to each other. The two businesses had different corporate cultures and, in fact, were essentially independent of each other. Simply stated, Mead and Lexis/Nexis did not have a unitary relationship.[4]

In 1994, Mead sold Lexis/Nexis and reported the gain from the sale, on its Illinois combined unitary income tax return, as nonbusiness income.[5] As nonbusiness income, the gain was not apportionable to Illinois and other States.

The Illinois Department of Revenue took issue with Mead's treatment of the transaction, asserting that

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[4] Below, the Appellate Court of Illinois did not review the lower court's decision regarding the lack of a unitary business finding. 371 Ill. App.3d 108, 117, 861 N.E.2d 1131, 1139 (2007).

[5] The transaction was structured as an asset sale.

the gain should have been classified as apportionable business income subject to tax in Illinois (and other States). Mead challenged the Department's classification of the gain. The Cook County Circuit Court agreed with Mead that Lexis/Nexis was not unitary with Mead, but nevertheless held that the gain from the sale of Lexis/Nexis was classified as apportionable business income because Mead's investment in Lexis/ Nexis served an "operational function." On appeal, the Illinois Appellate Court upheld the finding of the trial court. The Illinois Supreme Court declined to review the decision.

III. THE UNITARY BUSINESS PRINCIPLE IS ESSENTIAL TO PREVENTING MULTIPLE TAXATION

In *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959), this Court confirmed that "the entire net income of a corporation, generated by interstate as well as intrastate activities, may be fairly apportioned among the States for tax purposes by formulas utilizing in-state aspects of interstate affairs." *Id.* at 460. Hence, apportionment formulae are used to determine what part of a taxpayer's income may be properly taxed by the respective States. For example, under the Uniform Division of Income for Tax Purposes Act (UDITPA), the apportionment formula compares (1) the taxpayer's property, payroll, and sales (receipts) within the taxing State to (ii) the taxpayer's total property, payroll, and sales. UDITPA §§ 9-17. The purpose of the apportionment formula is to assign to the taxing State the amount of the taxpayer's total income that is earned in, and therefore is reasonably attributable to, the State.

The general permissibility of formulary apportionment, however, should not obscure the Constitution's limitation on the States' ability to tax out-of-state income. As the Court held in *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983), "[u]nder both the Due Process and Commerce Clauses of the U.S. Constitution, a State may not, when imposing an income-based tax, 'tax value earned outside its borders.'" *Id.* at 164 (quoting *ASARCO Inc. v. Idaho State Commission*, 458 U.S. 307, 315 (1982)). Consequently, formulary apportionment is permissible only to the extent that the result is a "'rough approximation' of the corporate income tax and is 'reasonably related to the activities conducted within the taxing state.'" *Exxon Corp. v. Department of Revenue*, 447 U.S. 207, 223 (1980) (quoting *Moorman Mfg. Co.*, 437 U.S. at 273-74). *See Wallace v. Hines*, 253 U.S. 66, 69 (1920) (Holmes, J.) (the purpose of apportionment formulae based on values both within and without a State is not "to open to taxation what is not within the State," but only to estimate the true values of the things within in it).

More than a century ago, this Court held that the taxability of a nondomiciliary taxpayer's out-of-state income turned on the application of the "unit rule" or the unitary business principle—on whether the out-of-state item sought to be taxed was "unitary" with, or functionally related to, the taxpayer's in-state activities. *State R.R. Tax Cases*, 92 U.S. 575, 608 (1875). In 1980, this Court encapsulated its prior holdings when it declared in *Mobil Oil Corp.* that the unitary business principle is the "linchpin of apportionability in the field of state income taxation." 445 U.S. at 439. Subsequently, *ASARCO* and *Container*

Corp. reaffirmed the unitary business principle and established standards for determining whether the requisite link exists between a nondomiciliary taxpayer's business activities within the State and its investments in or income from other entities.[6]

In *Allied-Signal*, the Court explained that the "unitary business rule is a recognition of two imperatives: the States' wide authority to devise formulae for an accurate assessment of a corporation's intrastate value or income; and the necessary limit on the States' authority to tax value or income that cannot in fairness be attributed to the taxpayer's activities within the State." 504 U.S. at 780. Under *Allied-Signal*, the Constitution permits the apportionment of income even in the absence of a formal unitary business where the asset (or transaction) in question serves an operational function rather than an investment function. 504 U.S. at 787. The Court explained that the inquiry whether an asset (or investment or transaction) serves an operational rather than investment function—

> focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing state. It is an inquiry to which our cases give content, and which is necessary if the limit of the Due Process and Commerce Clauses are to have substance in a modern economy.

Id. at 785.

In essence, the Court's operational-versus-investment function rule represents a gloss on the unitary business principle itself, born of the recognition that

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[6] *See also F.W. Woolworth Co.*, 458 U.S. at 364.

in certain circumstances (for example, in respect of venture capital or private equity firms) an enterprise's business operations may be the making of investments in other companies, even if the operations of these investments are not unitary with the enterprise's own operations. *See Adams Express Co. v. Ohio State Auditor*, 165 U.S. 194, 222 (1897) ("while the unity which exists may not be a physical unity, it is something more than a mere unity of ownership. It is a unity of use, not simply for the convenience or pecuniary profit of the owner, but existing in the very necessities of the case—resulting from the very nature of the business.")

Because the trial court found that there was not a unitary relationship between Mead and Lexis/Nexis, barring a recasting of the constitutional rule by the Court, the proper disposition of this case turns on the application of the operational-versus-investment function test.

IV. MEAD'S OWNERSHIP OF LEXIS/NEXIS SERVED AN INVESTMENT, NOT AN OPERATIONAL, FUNCTION

A. The Court Below Ignored the Teaching in *Allied-Signal*

The Appellate Court of Illinois determined that Mead failed its burden of proving "that Lexis/Nexis was not an operational asset," 371 Ill. App. 3d. at 117, 861 N.E.2d at 1139-40, but its analysis betrays a misapprehension of *Allied-Signal*. In reaching this conclusion, the lower court said: "Mead was 100% owner of Lexis/Nexis. Although Mead did not have day-to-day control over Lexis/Nexis, its involvement with Lexis/Nexis was more than merely passive." *Id.* at 118, 861 N.E.2d at 1140. Thus, under the Illinois

court's analysis, investments in all wholly owned companies would be treated as operational assets despite the lack of any unitary relationship between the company and the parent and without regard to why the company was acquired—despite, in other words, the connection required by the Commerce Clause to guard against extraterritorial taxation.

Simply stated, requiring gains from the sale of wholly owned companies, *ipso facto*, to be apportioned without requiring more would distend the unitary business principle that the Court articulated more than a century ago and vivified 15 years ago in *Allied-Signal*. There, the State of New Jersey urged the Court to abandon the unitary business principle and allow nondomiciliary states to apportion (and tax) all of a corporation's income without regard to whether the income has a connection with the nondomiciliary state. *Allied-Signal*, 504 U.S. at 784. This Court rightly rejected this theory as sweeping, citing a 1982 decision that held that the "*potential* to operate a company as part of a unitary business is not dispositive when, looking at 'the underlying economic realities of a unitary business' the dividend income from the subsidiaries . . . [was] derive[d] from 'unrelated business activity' which constitutes a 'discrete business enterprise.'" *F.W. Woolworth Co.*, 458 U.S. at 362 (quoting *Exxon Corp.*, 447 U.S. at 223-24 (emphasis in original)). Likewise, the mere (but not actual) potential to integrate a wholly owned business into the parent's operations, without more, is not enough to justify classifying the ownership as "operational" in nature.

The Illinois Appellate Court also said that apportionment is appropriate because Mead made contri-

butions of capital and "manipulated" Lexis/Nexis's structure by changing its form from a division to a corporate subsidiary. 371 Ill. App.3d at 118, 861 N.E.2d at 1140. It failed to explain adequately, however, how these activities bolstered its conclusion. Increasing the amount of capital invested in a subsidiary may merely reflect an owner/investor's decision that the subsidiary presents a greater opportunity for return than other investment options. Likewise, transforming a wholly owned subsidiary into a division (or vice-versa) may reflect nothing more than a decision how to hold or own an investment. Neither of these owner/investor decisions by itself reflects an operational purpose within the meaning of *Allied-Signal.*

B. The Hallmarks of an Operational Relationship

Whether an asset (or investment or transaction) serves an operational rather than investment function "focuses on the objective characteristics of the asset's used and its relation to the taxpayer and its activities within the taxing state." *Allied-Signal*, 504 U.S. at 785. This prompted the Court to find in *Allied-Signal* that "the payee and payor need not be engaged in the same unitary business as a prerequisite to apportionment in all cases. . . . What is required instead is that the capital transaction serve an operational rather than an investment function." 504 U.S. at 787. Thus, the connection of the asset or the transaction to the *operations* of the enterprise can, where strong enough, operate as a proxy for a formal finding of "unitariness."

Before *Allied-Signal*, the Court focused on the investment-versus-operational issue as part of its unitary analysis. For example, in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 180 (1983), the Court made clear that "capital transactions can serve either an investment function or an operational function," and found that foreign subsidiaries served an operational function as a result of *Container Corp.*'s loans and loan guarantees to these subsidiaries." In *Home Interiors and Gifts, Inc. v. Department of Revenue*, 318 Ill. App.3d 205, 741 N.E.2d 998 (Ill. App. 2000), *appeal denied*, 195 Ill. App.3d 552, 754 N.E.2d 1285 (2001), relying on *Allied-Signal* and *ASARCO*, the court stated that "in deciding whether funds in a short-term bank account serve an operational or investment function, the Supreme Court's decisions . . . confirm that the court must determine how the corporation use[d] the funds." *Id.* at 214, 741 N.E.2d at 1006. The court found that the passive investment income was not apportionable to Illinois "simply because Home Interiors used a small portion of its funds held for investment purposes for its working capital needs." *Id.* at 215, 741 N.E.2d at 1007.[7]

To be sure, the concept of "business-relatedness" is neither uniform nor susceptible to definitional precision. Beyond the three broad *unitary* themes of functional integration, centralization of management, and economies of scale, *Mobil Oil*, 445 U.S. at 438,

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[7] *See* 1 J.Hellerstein & W. Hellerstein, *State Taxation: Constitutional Limitations and Corporate Income and Franchise Taxes* ¶ 8.09[5][b][i], at S8-13 (3d ed. 2000 and 2006 Cumulative Supplement No. 2) (discussion of "thoughtful opinion" in *Home Interiors* distinguishing mere availability of capital from its actual use).

the following external and internal factors are indicative of an operational relationship:

Externally:

- Do the businesses at issue naturally fall within the same industry or industry segment?
- Do they share the same or closely similar customer bases?
- Do they share common marketing, advertising, and branding strategies?
- Do the businesses share common inputs, *e.g.*, infrastructure, sources of supply, and raw materials, as well as common outputs, *e.g.*, distribution channels, maintenance, support, and warranty mechanisms?

Internally:

- Do the businesses share services, *e.g.*, administrative or strategic?
- How have the respective strategic business plans been substantively developed?
- Are the business decision-makers who are involved in those processes and accountable for business results the same or different?

These criteria transcend the sometimes artificial and formulary distinctions often associated with the form and degree of ownership and focus instead on the essence of the relationship and the linkage between the entities—a linkage that must be substantial before the transaction or income is to be deemed apportionable and subject to tax.

Amicus TEI regrets that—absent the imposition of other, arguably more administratively burdensome and intrusive limitations—the distention of the operational-versus-investment test could eviscerate the protections of the unitary business principle and

thus convert the potential for duplicative taxation into reality. And given the Court's historical reluctance to dictate the specific components of a given State's allocation and apportionment scheme, *Moorman Mfg.*, 437 U.S. at 278-80, the development and imposition of such limitations are not guaranteed. A decision upholding the court below would allow the States to impose a tax on intangible income, without real regard to the connection between the income and the taxpayer's activities in the State.[8]

In short, the existence of an operational relationship cannot, as the Illinois Appellate Court seeks to do, be premised on shibboleths—code words extracted out of context and contorted to mean only what the State, like Humpty Dumpty in *Through the Looking Glass*, wants them to mean.[9] Instead, that determination must be grounded on characteristics of the business relationship that reveal the substantive nature of that relationship. Thus, if the core activity of an enterprise is the buying and selling of companies (*e.g.*, if it is a venture capital, buy-out, or private equity firm), then the money derived from the making of investments in its "targets" may properly be viewed as "operational" under *Allied-Signal*, even though the business of targets was never integrated into or made unitary with, the enterprise itself. That

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[8] A decision upholding the court below would not *require* all the States to apportion such income, only *free* them to do so, unfettered by the limitations inherent in the unitary business principle. At the same time, the State of commercial domicile would presumably retain the right to allocate the same income, thus raising the specter of multiple taxation.

[9] Lewis Carroll (Charles L. Dodgson), *Through the Looking Glass* ch. 6 (1865) ("'When I use a word,' Humpty Dumpty said, in a rather scornful tone, 'it means just what I choose it to mean—neither more than less.'").

situation, however, is completely different from the case here where Mead (a paper products company) invested in Lexis/Nexis.[10]

Let stand, the Illinois decision will lead to multiple taxation of extraterritorial income by permitting the apportionability of income based on the most attenuated of relationships. Thus, the situation is not much different from when the Court stanched the effort of New Jersey in *Allied-Signal* and vivified the unitary business principle. Accordingly, the Illinois decision below was erroneous and should be reversed.

CONCLUSION

For the foregoing reasons, the decision of the Appellate Court of Illinois should be reversed.

Respectfully submitted,

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[10] See 1 J. Hellerstein & W. Hellererstein, *supra*, ¶ 9.11[1][c], at 9-99 (if a company "was in the business of buying or selling other businesses, the stock of [those] other corporations surely served an 'operational function' in its business.").

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IN THE

Supreme Court of the United States

MEADWESTVACO CORPORATION,
SUCCESSOR IN INTEREST TO THE MEAD CORPORATION,
Petitioner,

v.

ILLINOIS DEPARTMENT OF REVENUE,
DIRECTOR OF THE ILLINOIS DEPARTMENT OF
REVENUE, AND TREASURER OF THE
STATE OF ILLINOIS,
Respondents.

ON WRIT OF CERTIORARI TO THE
APPELLATE COURT OF ILLINOIS

BRIEF FOR THE WALT DISNEY COMPANY AS AMICUS CURIAE SUPPORTING PETITIONER

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QUESTION PRESENTED

Whether a state may, consistent with the Commerce Clause and Due Process Clause, tax a non-domiciliary corporation on the gain from its sale of stock in another non-domiciliary corporation that it held for investment purposes on the ground that the parent's investment in, oversight of, and sale of the subsidiary served an "operational function."

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ON WRIT OF CERTIORARI TO THE
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BRIEF FOR THE WALT DISNEY COMPANY AS AMICUS CURIAE SUPPORTING PETITIONER

INTEREST OF AMICUS CURIAE

The Walt Disney Company is a diversified entertainment company and the parent corporation of a group of affiliated companies with operations through-

out the United States and around the world.[1] In the course of its business, Disney has often acquired substantial shares of other companies and held them for investment purposes. Disney is a publicly traded company and is required to file various public documents with the Securities and Exchange Commission. In compliance with SEC reporting requirements, Disney employs a consolidated reporting regime to reflect Disney's overall financial performance for each reporting period, including the performance of its investment holdings. Like petitioner, Disney utilizes a cash management system to maximize the earning potential of its cash holdings and those of its subsidiaries for the benefit of its shareholders. Also like petitioner, Disney is currently involved in litigation with the Illinois Department of Revenue concerning whether proceeds from the sale of shares in a business held for investment purposes constitute apportionable income.

SUMMARY OF ARGUMENT

I. A state may not tax revenue earned by an out-of-state corporation unless that value is fairly attributable, at least in part, to in-state activity. This Court has developed the unitary business principle to detect instances where states overreach by attempting to tax revenue that they are not entitled to share. That principle reflects and enforces the due process and com-

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[1] The parties have consented to the filing of this brief. No counsel for a party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than amicus curiae or its counsel made a monetary contribution to its preparation or submission.

merce clause concerns that underlie the limitations on state taxation.

In *Allied-Signal, Inc.* v. *Director, Division of Taxation*, 504 U.S. 768 (1992), this Court recognized that, in addition to the revenue generated by a corporation in the course of its unitary business, states possess the power to tax revenue generated through a capital transaction that serves an operational function. The operational function test was not intended to erode the important limits of the unitary business principle, rather, it was only intended as a narrow supplement to that principle.

The Appellate Court of Illinois, however, has mistakenly read the operational function test as a radical expansion of state taxation power. That misinterpretation led it to uphold an exaction on revenue that petitioner earned outside Illinois, that had no rational nexus to Illinois, and to which Illinois had contributed no value. This reading of the operational function test, if adopted, will free states to impose arbitrary and unreasonable taxes on multi-state businesses.

II. The Appellate Court of Illinois mistook numerous factors as indicative of operational control of a subsidiary when those factors are wholly consistent with the subsidiary being held only for investment purposes. The practical implication of allowing those factors to be incorporated into the apportionment analysis is to penalize companies that act in full compliance with accounting and reporting requirements and engage in responsible oversight of their investments.

III. As a side-effect of beneficial mergers and acquisitions, companies frequently come to control subsidiaries that provide no economic value to their other holdings. The analysis employed by the Appellate

Court of Illinois will sometimes raise transaction costs for such acquisitions.

IV. If the operational function test is allowed to substantially erode the limits of the unitary business principle, companies will be penalized for having structured transactions to conform to *Allied-Signal*. It will also raise the substantial specter of double taxation.

ARGUMENT

I. THE COURT BELOW FUNDAMENTALLY MISAPPREHENDED AND MISAPPLIED THE OPERATIONAL FUNCTION TEST ARTICULATED IN *ALLIED-SIGNAL*

The Constitution generally prohibits states from taxing non-domiciliary corporations on revenues earned outside the taxing state. Two rules provide important, but limited, exceptions to this general prohibition. One, the "unitary business" principle, articulates the primary basis on which states may reach the out-of-state revenues of out-of-state corporations and has been termed the "linchpin" of the analysis as to whether such taxation is permissible. *See Mobil Oil Corp.* v. *Vermont Comm'r of Taxes*, 445 U.S. 425, 439 (1980). The unitary business principle is supplemented by the "operational function" test, which allows states to go beyond the unitary business principle to reach a narrow class of capital transactions occurring outside their borders. *See Allied-Signal, Inc.* v. *Director, Div. of Taxation*, 504 U.S. 768, 787 (1992).

In the proceedings below, the court permitted Illinois to tax revenue generated by petitioner Mead Corporation, which is incorporated in Ohio, through the sale of Lexis/Nexis, an entity unrelated to Mead's business activities in Illinois. The court expressly disclaimed any reliance on the unitary business principle,

concluding that the tax was defensible strictly based on the operational function test. In doing so, the court stretched the meaning of operational function beyond all reasonable bounds.

A. The Unitary-Business Principle Is, For Good Reasons, The Principal Test For Assessing Whether A State May Tax An Out-of-State Corporation's Revenues Earned Out Of State

"[A] State may not tax value earned outside its borders." *Allied-Signal*, 504 U.S. at 777. This principle finds support in two constitutional provisions. The dormant Commerce Clause prohibits extraterritorial taxation because of the burden on interstate commerce that would result if states were permitted to tax activity occurring in other states. *See Mobil Oil*, 445 U.S. at 443. In addition, the Due Process Clause prohibits such taxation because it would be arbitrary and unfair for a state to tax activity without "some minimal connection between those activities and the taxing state" and unless "the income attributed to the State for tax purposes [is] rationally related to 'values connected with the taxing State.'" *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267, 273 (1978) (quoting *Norfolk & W. Ry. Co.* v. *Missouri State Tax Comm'n*, 390 U.S. 317, 325 (1968)).

These constitutional principles have particular importance where, as in this case, a state attempts to tax revenues earned by an out-of-state corporation. As this Court has made clear, when a state imposes taxes on non-domiciliary corporations, it does so not out of sovereign right, but only as a fair "price for the privileges it afforded foreign corporations within its borders." *Wisconsin* v. *J.C. Penney Co.*, 311 U.S. 435, 442 (1940). Where a state attempts to tax an out-of-state corporation on activities that take place entirely outside the

state's borders, there is a danger that exaction will be more in the "nature of an extortion than a tax." *Union Refrigerator Transit Co.* v. *Kentucky*, 199 U.S. 194, 202 (1905).

This Court has also recognized, however, that when a business operates in multiple jurisdictions, the whole is often worth more than the sum of the constituent parts. *See Ford Motor Co.* v. *Beauchamp*, 308 U.S. 331, 337 (1939). As a result, unless states are allowed to look to the value of the corporation in its entirety, they are likely to undervalue their fair share of corporate revenue. This will frustrate their legitimate interest in revenue collection. Therefore, under appropriate circumstances, states may engage in "apportionment"; that is, they may tax a proportional share of a multi-state corporation's entire revenue, even that earned out of state.

Yet not all revenue produced by multi-state corporations can fairly be treated as apportionable. After all, the "only reason for allowing a State to look beyond its borders when it taxes the property of foreign corporations is that it may get the true value of the things within it." *Norfolk & W. Ry.*, 390 U.S. at 325 n.6 (quoting *Wallace* v. *Hines*, 253 U.S. 66, 69 (1920)). This is only true when in-state properties are "part of an organic system of wide extent, that gives them a value above what they otherwise would possess." *Id.*

As this case demonstrates, there are often occasions when a multi-state corporation will come to own an interest—sometimes even a controlling interest—in a business operating in an industry wholly unrelated to its own. Often, these holdings are not part of the corporation's "organic system"; they are distinct from the operations of their owner and they do not make the

constituent parts of the owner's business any more valuable. Under such circumstances, there is no justification for extraterritorial taxation.

This Court developed the "unitary business" principle to identify those circumstances in which it is reasonable for states to tax an apportioned share of corporate revenue. *See ASARCO, Inc.* v. *Idaho State Tax Comm'n*, 458 U.S. 307, 320 n.14 (1982) (collecting cases detailing the evolution of the unitary business principle). Under the unitary business rule, states may apportion all of a multi-state business's revenue that is generated in the conduct of its unitary business, but are not entitled to a share of the proceeds from "unrelated" business activity. *F.W. Woolworth Co.* v. *Taxation & Revenue Dep't of N.M.*, 458 U.S. 354, 362 (1982). The Court has further clarified that three factors are "the hallmarks" of a unitary business: functional integration, centralization of management, and economies of scale between the entities that compose the business organization. *Allied-Signal*, 504 U.S. at 789.

These three factors demonstrate that the constituent entities of the unitary business are not merely related, but also create value for one another. In the presence of these factors, courts can reliably conclude that the in-state property possesses "enhanced value" stemming from its relationship with a larger system, *Pullman Co.* v. *Richardson*, 261 U.S. 330, 338 (1923), and that due process will not be offended by having the state apportion a share of the corporation's entire revenue. Thus, the unitary business principle employs metrics specifically tailored to the due process concerns regarding extraterritorial taxation.

B. *Allied-Signal*'s Discussion Of Operational Functions Was Designed To Provide Only A Narrow Supplement To The Unitary Business Rule

Given that the unitary business principle largely addresses the due process and commerce clause concerns underlying the restrictions on the apportionment of out-of-state income, it should come as no surprise that it has been the dominant mechanism for determining whether income may be apportioned. This Court has repeatedly called the unitary business principle the "linchpin of apportionability." *See F.W. Woolworth*, 458 U.S. at 362 (quoting *ASARCO*, 458 U.S. at 319 (quoting *Exxon Corp.* v. *Wisconsin Dep't of Revenue*, 447 U.S. 207, 223 (1980) (quoting *Mobil Oil*, 445 U.S. at 439))). It has also stated that "'[f]ormulary apportionment, which takes into account the entire business income of a multistate business in determining the income taxable by a particular state, is constitutionally permissible *only* in the case of a unitary business.'" *ASARCO*, 458 U.S. at 320 n.14 (quoting Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 Tax L. Rev. 171, 183-184 (1970) (alteration in original) (emphasis added)). In *Allied-Signal*, the Court's most recent case on the subject, New Jersey urged the Court to abandon the unitary business principle, and the Court emphatically declined the invitation and reaffirmed the principle's primacy in the due process and commerce clause analyses. 504 U.S. at 785.

Despite the Court's heavy reliance on the unitary business principle, the concept does not quite reach the entire universe of situations where revenue generated out of state may be apportionable. That is because the unitary business principle, and the three factors it con-

siders, are only suited to assess whether different sets of *business activities* are sufficiently related to be considered unitary. The rule is not readily adaptable to capital transactions, particularly those undertaken with unrelated parties such as banks.

The issue of capital transactions was discussed in *Container Corp. of America* v. *Franchise Tax Board*, 463 U.S. 159 (1983). The Court noted that "capital transactions can serve either an investment function or an operational function." *Id.* at 180 n.19. It drew this principle from a case holding in a different context that when a business purchases futures or options as a hedge against changes in market conditions within its field of business, those futures serve an operational rather than an investment function. *See id.* (citing *Corn Prods. Refining Co.* v. *Commissioner*, 350 U.S. 46, 50-53 (1955)). Although the Court stated that revenue generated through operational functions is apportionable, while investment income is not, it provided little further clarification.

The *Allied-Signal* Court expanded on the discussion in *Container Corp.*, and articulated the relationship between operational functions and the unitary business principle. The Court stated that "the payee and the payor need not be engaged in the same unitary business as a prerequisite to apportionment in all cases[.] What is required instead is that the capital transaction serve an operational rather than an investment function." 504 U.S. at 787. An operational function analysis "focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State." *Id.* at 785.

Although the Court did not provide any further definition of an operational function, it gave an example

of a capital transaction that would qualify. Specifically, revenue produced through "short-term investment of working capital analogous to a bank account or certificate of deposit" is apportionable on that rationale. 504 U.S. at 790.

The Court also noted two factors it deemed irrelevant to whether a capital transaction is operational. First, "the mere fact that an intangible asset was acquired pursuant to a long-term corporate strategy of acquisitions and dispositions does not convert an otherwise passive investment into an integral operational one." 504 U.S. at 788. Second, the intended (or even actual) future use of the proceeds, *i.e.*, the gain from the sale of an investment asset, cannot be used to convert what would be non-apportionable income into apportionable income. *See id.* at 789.

Although the Court did not define the full scope of the operational function text in *Allied-Signal*, it gave no indication that it was recognizing a broad new category of apportionable revenue or that it was retreating from the understanding that the unitary business principle is the "linchpin" of the apportionability analysis. Therefore, it seems safe to draw three conclusions regarding the "operational function" category.

First, it applies only to capital transactions; the Court gave no indication that *business activity* should not continue to be assessed exclusively under the unitary business principle.

Second, the example selected by the Court suggests that the theory underlying the operational function category is that some capital transactions may be so intimately tied to the business of a corporation that those transactions are part of the value of that business, even though in some respects they appear to be

mere investment activity. For example, holding operating capital in a bank is activity frequently undertaken as part of the day-to-day operation of a business. Consequently, any revenue that activity produce can fairly be classified as revenue of that business and apportioned, even if the revenue was not generated through sales or other traditional sources of business revenue.

Finally, the proper analysis turns on whether a capital transaction, such as investment in or sale of a subsidiary, served an operational function in *the owner's* business—not in the business of the subsidiary. Therefore, the fact that a subsidiary receives some value from oversight from the parent does not make the relationship operational. *See Container Corp.*, 463 U.S. at 180 n.19 (citing *F.W. Woolworth*, 458 U.S. at 369). However, a series of loans from the parent to the subsidiary may serve an operational function if they were undertaken to improve the *parent's* profitability. *See id.* Thus, the relevant inquiry is whether "the function of the investment is to make better use ... of the *parent's* existing business-related resources." *Id.* at 178 (emphasis added). Bank accounts and hedging investments may meet these criteria; oversight of an investment in an unrelated business will not.

C. The Court Below Misconstrued The Breadth Of The Operational Function Category And Treated It More Expansively Than This Court Intended

In the decision below, the Appellate Court of Illinois latched on to the "operational function" language from *Allied-Signal* and upheld Illinois's attempt to tax petitioner on the sale of an investment held in Ohio, wholly unrelated to the petitioner's business activities in Illinois. *See* Pet. App. 1a-22a. That court failed to

read *Allied-Signal* for what it is: a strong reaffirmation of the right against arbitrary apportionment. Instead, it focused on the narrow clarification regarding the treatment of capital transactions and deduced from it an exception sufficient to swallow the rule.

This decision to employ an operational function rather than a unitary business analysis was crucial to the outcome below. It allowed the court to ignore factual findings by the trial court that Mead and Lexis/Nexis were not functionally integrated, did not have centralized management, and did not enjoy economies of scale. Under Illinois law, these factual findings were entitled to substantial deference and could be reversed only if they were contrary to the manifest weight of the evidence. *See* Pet. App. 7a. These three findings, taken together, are more than sufficient to preclude a finding that Mead and Lexis/Nexis were a unitary business because functional integration, centralization of management, and economies of scale are the "hallmarks of an acquisition that is part of the taxpayer's unitary business." *Allied-Signal*, 504 U.S. at 789.

Moreover, while the Appellate Court of Illinois insisted that it was employing an operational function analysis, the specific factors it considered bear no logical relationship to that test (as opposed to a unitary business analysis). The court did not examine, for example, whether Mead invested in Lexis/Nexis to facilitate its business activities (the production and sale of forestry products). It did not look to whether the money infused into Lexis/Nexis represented a short-term investment of working capital (which it clearly did not). It likewise did not attempt to determine whether Mead's ownership of Lexis/Nexis constituted a hedge against a change in market conditions in the forestry

products industry. Thus, although the operational function analysis is supposed to turn on the asset's "relation to the taxpayer and its activities within the taxing State," *Allied-Signal*, 504 U.S. at 785, the court undertook no examination of Lexis/Nexis's relation to Mead's business activities in Illinois (namely, the production and sale of forestry products), or how Mead's ownership of Lexis/Nexis might have facilitated those business activities.[2]

In fact, the court did not treat Mead's investment in Lexis/Nexis as a capital transaction at all. Instead, it looked to the relationship between the two companies, particularly the degree to which Mead managed Lexis/Nexis—precisely the domain of the unitary business principle. Thus, the court emphasized that Mead was the 100% owner of Lexis/Nexis, contributed capital support, approved major expenditures, changed the placement of Lexis/Nexis within the overall Mead corporate family, obtained tax benefits, and exercised control over excess cash. Pet. App. 12a-13a. These factors might have been relevant to ascertaining whether Lexis/Nexis was part of Mead's unitary business, *cf. Allied-Signal*, 504 U.S. at 789, but they do not sensibly

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[2] The trial court finessed this issue by making a finding that "Mead was involved in the electronic publishing business." Pet. App. 36a. Based on that finding, the trial court concluded that Mead's investment in Lexis/Nexis served the operational function of facilitating Mead's electronic publishing business. The problem with this approach is that it rests on a tautology: Mead's ownership of Lexis/Nexis facilitated its business of electronic publishing, which consisted entirely of owning and investing in Lexis/Nexis. If this reasoning were sufficient to satisfy the operational function test, there would be little, if anything, of substance left to that test or to the unitary business principle, which the operational function test supplements in a limited way.

speak to whether Mead's investment in Lexis/Nexis served an operational function.[3]

Ownership and control cannot be dispositive, or even particularly probative, in the operational function analysis. A capital transaction inherently concerns the disposition of an asset—that is to say, ownership and control are at issue in *every* capital transaction.[4] Thus, bank accounts funded with working capital and options bought to hedge against changes in market conditions are under the complete control of the corporation that owns them. So, too, however, are passively held shares of stock acquired strictly for investment purposes.

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[3] The court's method of analysis affected its citation of authorities as well; the precedents it relied on are unitary business precedents. For example, the court quoted *Allied-Signal* for the premise that a "company's 20.6% ownership of subsidiary's stock did not establish [an] *operational relationship*." Pet. App. 13a (citing *Allied-Signal*, 504 U.S. at 788) (emphasis added). Yet the cited discussion does not come from *Allied-Signal*'s description of the operational function category; rather, the statement reads in full that "because Bendix owned only 20.6% of ASARCO's stock, it did not have the potential to operate ASARCO as an integrated division of a single *unitary business*." *Allied-Signal*, 504 U.S. at 788 (emphasis added). The same is true of the only other authority the court cited in the course of analyzing the operational function question. It attributed to the *ASARCO* Court the conclusion that "bare majority ownership of subsidiary's stock [was] not enough to show [an] *operational relationship* in light of lack of ability to control [the] subsidiary." Pet. App. 13a (citing *ASARCO*, 458 U.S. at 321-322) (emphasis added). The Court's actual conclusion was that the two businesses being evaluated were "insufficiently connected to permit the two companies to be classified as a *unitary business*." *ASARCO*, 458 U.S. at 322 (emphasis added).

[4] For example, even the sale or purchase of a non-controlling interest in a corporation implies ownership or control of the capital asset, namely the shares of stock.

What distinguishes the former from the latter is not control, it is the *function they serve in facilitating the owner's business*. If assets facilitate the owner's business, the gain on their sale may well be apportionable; if they are held only for investment purposes, then the Constitution limits the states' ability to reach them for taxing purposes.

II. The Court Below Relied On Factors That Are Not Probative In Either The Unitary Business Or Operational Function Analysis

The Appellate Court of Illinois not only fundamentally misapprehended the purpose of the operational-function test; in supposedly applying that test, it relied on factors that are not probative of whether a state should be allowed to tax the out-of-state activity of out-of-state corporations under either the operational function or the unitary business approach.

Although the constitutional test for apportionability is "quite fact sensitive," *Allied-Signal*, 504 U.S. at 785, that does not mean that all facts are probative of that question. As explained below, several factors emphasized by the court shed little light on the issue of apportionability, for they are as consistent with one corporation owning another for investment purposes as they are with a corporate parent exercising operational control over a subsidiary. Use of those factors only muddies the waters, and, if relied on in other cases, could dramatically expand the reach of state taxation.

A. Cash Management

The Appellate Court identified petitioner's cash management system as a factor favoring apportionability of the proceeds of petitioner's investment in Lexis/Nexis. The court stressed that petitioner made

nightly cash sweeps of Lexis/Nexis's bank accounts and noted that, although petitioner invested the funds for Lexis/Nexis's benefit, it did so in a manner decided by petitioner. Pet. App. 3a.

This court's reliance on cash management systems is ill-considered, for it fails to recognize the widespread and entirely appropriate role of cash sweeps. Daily cash sweeps from subsidiaries, including non-unitary subsidiaries, are common within any large business organization. Cash sweeps are typically performed for purposes of cash control. Usually, the subsidiary records an account receivable in the amount of the sweep and the parent corporation, which sweeps the cash, records an account payable in its books in the same amount to document the transaction. Similarly, any interest earned on the swept cash is recorded, and reported for tax purposes, as income of the entity to which the cash belongs, *i.e.*, the entity from which the cash was initially swept.

A cash management system within a business organization is essentially an administrative mechanism. It is designed to provide accountability and limit the dispersion of liquid assets. It also allows for a maximization of the return that may be produced through consolidated investing. It is standard operating practice in many large business organizations and is routinely used in connection with subsidiaries over which the parent does not exercise managerial control.

Therefore, the mere existence of a cash management system is not relevant to an apportionability determination. Even when a subsidiary's cash is swept by the parent, it is often held for the benefit of the subsidiary and is not a font of operating capital for the owner. In such circumstances, the subsidiary's cash

does not serve an operational function for the parent. Moreover, because a cash sweep can be performed for any cash-producing subsidiary, even one in a "discrete" line of business, *ASARCO*, 458 U.S. at 320, it does not establish the existence of a unitary business. Cash sweeps do not suggest that the subsidiary is somehow producing value for the parent such that a non-domiciliary state is entitled to a share of the subsidiary's revenue.

B. Consolidated Reporting

The court below also improperly considered petitioner's consolidated reporting regime as a relevant factor in determining whether petitioner's investment in Lexis/Nexis served an operational or an investment function. Pet. App. 3a-4a, 13a. Petitioner, like other business organizations, utilized consolidated reporting in its financial statements, annual reports and other documents that, as a public company, it is required to file with the Securities and Exchange Commission. Consolidated reporting is often required for financial reporting purposes that have nothing to do with any factors that might be relevant to an apportionability analysis. Reporting is intended to provide useful information to investors and regulators, who may not be particularly concerned with whether a subsidiary served an operational function of a corporate parent.

Reporting requirements are framed in terms that have no particular relationship to the operational-function test for apportionability. Standards issued by the Financial Accounting Standards Board mandate the "way that public business enterprises report information about operating segments in annual financial statements and requires that those enterprises report selected information about operating segments in interim

financial reports issued to shareholders." *Statement of Financial Accounting Standards No. 131, Disclosures about Segments of an Enterprise and Related Information* 4 (*FAS 131*). *FAS 131* expansively defines "operating segment" as

> a component of an enterprise: (a) That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same enterprise), (b) Whose operating results are regularly reviewed by the enterprise's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and (c) For which discrete financial information is available.

Id. at 7. None of these factors suggests that an "operating segment" must facilitate or even be related to the reporting corporation's line of business. The fact that a corporation owns another company that is engaged in an operating business does not mean that the business is used in the operation of the parent company, as opposed to being held for investment purposes. Accordingly, the petitioner's decision to report on all "operating segments," as defined under *FAS 131*, should not influence the proper tax treatment of the gain on its sale of its stock in Lexis/Nexis.

C. Oversight Of Major Expenditures

The court below also relied on petitioner's approval of major debt and major capital expenditures by Lexis/Nexis in concluding that petitioner's investment in Lexis/Nexis served an operational rather than an investment function. Pet. App. 13a. Reliance on this fac-

tor is also misplaced, for prudent investors frequently retain the right to approve or at least be consulted on major expenditures without becoming involved in the operation of the company in which they invest—much less making that company involved in their own operations, which is the inquiry to which the operational-function test is directed.

Responsible investors routinely monitor significant expenditures of the businesses they own. In fact, this Court has explicitly recognized that there is a "type of occasional oversight—with respect to capital structure, major debt, and dividends—that any parent gives to an investment in a subsidiary." *F.W. Woolworth*, 458 U.S. at 369. Similarly, venture capitalists investing in companies often require advance notification of and the right to approve major items of expenditure, including extraordinary transactions such as the incurrence of major debt and major capital expenditures. The right to approve such transactions is a measure of prudent investment, not operational function or a unitary business. Thus, creditors of companies, such as banks, often restrict the activities of debtor companies and require consent for extraordinary transactions so as to protect their investment, but such restrictions obviously do not convert the creditor and debtor into a unitary business. To be sure, oversight of major expenditures can also be consistent with a unitary relationship. But that is only the case when the "management role that the parent does play is grounded in its own operational expertise and its overall operational strategy." *Container Corp.*, 463 U.S. at 180 n.19. Under such circumstances, the monitoring is in actuality a form of "uncompensated technical assistance." *Id.*

Thus, in that absence of other factors, supervision of an investment does not make the revenue generated

by that investment apportionable. What is properly considered is whether the parent participated in management by utilizing expertise borne from engaging in the same line of business. In the absence of that factor, companies should not be penalized for protecting their shareholders' assets by insuring that their subsidiaries spend responsibly.

D. Investment Of Capital

A final factor on which the court below placed undue reliance was petitioner's history of making capital contributions to Lexis/Nexis. Pet. App. 13a. Investors frequently make capital contributions to companies in which they are investing without thereby creating an operational or unitary relationship. For example, venture capitalists frequently agree to make continuing capital contributions to start-up companies, but in such situations, no one would suggest that the venture capital company and the investment vehicle became a unitary business or were even operationally related. More generally, investors have a significant interest in ensuring that the businesses in which they invest are successful. This is most true when there is only one investor in the business since that investor carries all of the risk and enjoys all the potential reward. If the influx of capital is necessary in the early years of an investment, or even later because of a change in economic conditions, the investor has an incentive to contribute the capital necessary to promote the success of the business and, ultimately, his investment. Such investments, however, ordinarily do not create a unitary or operational relationship.

This Court has in the past looked to whether the parent invested capital in determining whether a subsidiary was involved in a unitary business. *See, e.g.*,

Container Corp., 463 U.S. at 179 (noting that the parent lent funds and offered loan guarantees to the subsidiary); *F.W. Woolworth*, 458 U.S. at 366 (noting that "each subsidiary was responsible for obtaining its own financing from sources other than the parent"). The flow of capital thus can be pertinent, on occasion, to whether income produced by the subsidiary is apportionable. Nonetheless, it would make little sense to treat this factor as determinative or even particularly probative.[5] As noted above, prudent investing often requires following an initial investment with the introduction of further funding. In this case, for example, it appears that Mead contributed capital support until Lexis/Nexis became profitable. That course only shows, however, that Mead made a wise decision not to abandon an initially unprofitable investment; it does not establish that Lexis/Nexis supported Mead's core lines of business.

If a single large initial investment does not create a unitary relationship, it is difficult to see why two smaller investments made sequentially should be treated differently. There are no additional ties in the second scenario that justify state apportionment. In the absence of other factors, infusing additional capital into a subsidiary should not be deemed to create a sufficient link between the subsidiary and the parent to justify extraterritorial state taxation.

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[5] In fact, it appears that the Court has, on at least one occasion, found that a secondary investment in a corporation did not render that subsidiary's revenue apportionable. *See F.W. Woolworth*, 458 U.S. at 366 n.14.

III. THE APPELLATE COURT'S APPROACH WOULD BURDEN ECONOMICALLY BENEFICIAL MERGER AND ACQUISITION ACTIVITY

Merger and acquisition activity forms a significant component of the United States' economy. In 2006, the aggregate volume of these transactions was $1.56 trillion dollars. Berman, *Year-End Review of Markets & Finance 2006—Can M&A's 'Best of Times' Get Better? —Private Equity Fuels A Frenzy of Deals; Cash on Sidelines*, Wall St. J., Jan. 2, 2007, at R5. Mergers and acquisitions occur regularly in many industries. These combinations are often beneficial to both consumers and to the economy. "Merging parties may reduce their costs by combining complementary assets, eliminating duplicate activities, or achieving scale economies. Mergers also may lead to enhanced product quality or to increased innovation that results in lower costs and prices or in more rapid introduction of new products that benefit consumers." United States Department of Justice & Federal Trade Commission, *Commentary on the Horizontal Merger Guidelines* 49 (Mar. 2006), *available at* http://www.usdoj.gov/atr/public/guidelines/215247.pdf.

The approach taken by the Illinois court could well hamper such economically beneficial merger and acquisition activity. When one corporation acquires another, it must often agree to take control of assets or lines of business it does not find desirable or synergistic. "[A target] will often have assets that [a would-be purchaser] does not want to own, directly or indirectly, after the acquisition ('unwanted assets')." Ginsburg & Levin, *Mergers, Acquisitions, and Buyouts: A Transactional Analysis of Governing Tax, Legal, and Accounting Considerations* ¶ 106.10, at 1-32 (Dec. 2003). Yet frequently, a target "may offer to sell itself only as

a 'complete' entity, either by selling all of its assets or by being the subject of a stock acquisition." Phillips & Rothman, 770-3rd Tax Mgmt. Portfolios, *Structuring Corporate Acquisitions—Tax Aspects*, A-153 (2005). As a result, corporations can often come to own subsidiaries or divisions that do not enhance the value of their other holdings.

Under these circumstances, the acquirer will frequently take steps to dispose of the unwanted asset. However, for a variety of reasons, including market timing, an acquirer may find it prudent to hold the asset for a time until a more profitable opportunity to dispose of it arises. In the interim, the acquirer has little choice but to allow the unwanted unit to continue to operate as a going concern. In this manner, a line of business can become an investment.

When forced to maintain an unwanted line of business, the acquirer may well leave pre-existing management in place since they have the expertise to run that business. Yet while the acquirer does not want to be burdened with running the unwanted business, it does have a strong incentive to engage in monitoring so as to insure that it receives full value when disposition of the asset ultimately occurs. Moreover, for administrative and regulatory reasons, the company may have little choice but to treat the unwanted division similarly to its other holdings and will therefore perform cash sweeps and issue consolidated reporting statements.

In short, the acquirer has good reason to engage in many of the activities highlighted by the Illinois court. Yet despite these factors, the unwanted business is still a separate entity being run by its own management. And crucially, none of these activities alters the fact that the acquirer's other holdings are in no way en-

riched by the addition of the unwanted asset to the corporate family. In constitutionally significant respects, it is a passive investment.

This Court's decision in the present case will have a significant impact on the state tax characterization of any gain or loss recognized upon the ultimate disposition of such unwanted assets. Under the unitary business and operational function tests as described in *Allied-Signal*, this sort of unwanted business could be acquired, held, and disposed of without generating apportionable income. This is appropriate because the asset neither increases the value of the company's other holdings nor operationally facilitates those other business activities. Sustaining the decision below, however, and endorsing the factors and analysis employed in reaching it, will likely convert the gain realized upon the eventual sale of this non-unitary business into apportionable income.

This outcome may in some cases effectively impose a tariff on otherwise desirable mergers. Companies deciding whether to acquire another corporation would have to factor in the negative tax consequences (perhaps in many states, if other states follow Illinois's lead) of holding on to a line of business that they might otherwise find undesirable, but that might provide an acceptable investment opportunity until the time was right to divest the holding. Presumably, some companies would find those tax consequences sufficiently adverse that they would resort to expensive and needlessly complicated arrangements such as internally reorganizing the structure of businesses or spinning off the unwanted entity. In short, the construction adopted below raises transaction costs and burdens business in a manner that serves no socially or eco-

nomically useful function. A constitutional rule that would inevitably yield such costs should be rejected.

IV. Adoption Of The Decision Below Would Upset Tax And Business Decisions Made In Reliance On *Allied-Signal*

The anticipated state tax consequences of mergers and acquisitions affect how those transactions are structured and priced. For fifteen years, a narrow construction of the operational function test, consistent with its articulation in *Allied-Signal*, has been relied on by business organizations throughout the country contemplating such transactions. Sustaining the Illinois court's decision in this case, even if it did not amount to a formal overruling of *Allied-Signal*, would repudiate that decision in effect and would certainly indicate that those companies had been dramatically wrong in their understanding of this Court's articulation of the constitutional limits on state apportionment. An affirmance would effectively penalize companies that structured transactions in the reasonable belief that, so long as they did not integrate subsidiaries and divisions into their primary business activities and did not exploit them operationally, they would not be expected to apportion any income generated by those subsidiaries.

This Court has previously taken cognizance of the reliance interests of businesses when adjudicating cases concerning the limits of state taxation. In *Quill Corp.* v. *North Dakota*, 504 U.S. 298, 316 (1992), this Court noted that businesses develop settled expectations in reliance on Supreme Court tax jurisprudence, and that the expectation of jurisprudential stability leads to beneficial investment and economic growth. Likewise, the *Allied-Signal* Court rejected New Jersey's challenge to the unitary-business principle in part

because "industry's reliance justifies adherence to precedent." 504 U.S. at 783 (citing *Quill Corp.*, 504 U.S. at 316).

Particularly, affirmance of the decision below could effectively result in multiple taxation, contrary to the uniform expectation of both taxpayers and states. In most circumstances, intangible income, such as capital gain from investments, traditionally has been treated as non-apportionable income, which may be taxed in its entirety by the taxpayer's state of domicile. *Allied-Signal*, 504 U.S. at 785; *Mobil Oil*, 445 U.S. at 445-446. A change in this treatment is likely to be resisted by domiciliary states, who understandably have come to rely on intangible income as a source of taxation. Thus, even as non-domiciliary states seek to tax an apportioned *share* of out-of-state intangible income on the ground that it serves an operational function, states of domicile may well seek to retain their right to tax *all* of that income. The inevitable consequence will be unfair multiple taxation and conflict among the states. This Court should avoid endorsing an approach to taxation that will have such negative consequences.

CONCLUSION

The decision of the Appellate Court of Illinois should be reversed.

Respectfully submitted.

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